THE VALUATION OF PROPERTY

VOLUME I

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Another Book on Valuation
published under the auspices of the
Columbia University Council
for Research in the Social Sciences

VALUATION
UNDER THE LAW OF EMINENT DOMAIN

A Complete Coverage of the Law of Valuation under Eminent Domain Based on an Analysis of the Reported Court Decisions and Commission Cases and on a General Study of All Types of Valuation of Property by the Courts.

By LEWIS ORGEL
Assistant Corporation Counsel of the City of New York

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THE VALUATION OF PROPERTY

A Treatise on the Appraisal of Property for Different Legal Purposes

VOLUME I

BY

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FIRST EDITION
FOURTH IMPRESSION

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To

IRVING W. BONBRIGHT

with Appreciation and Affection

PREFACE

This treatise presents the results of a research in legal and economic theories of property valuation, prepared under the direction of the author and under the auspices of the Columbia University Council for Research in the Social Sciences. As with all other studies supported by the Council, the analysis and conclusions are those of the author and his associates, who alone assume responsibility therefor.

Although the present work covers almost the entire study, it omits a detailed treatment of several of the topics to which we have devoted separate monographs or articles. A list of these publications is given below. To the titles of three of the articles are attached asterisks in order to indicate that they are so largely reprinted in this work as hardly to repay the attention of the present reader. Acknowledgments are due to the Columbia Law Review for kind permission to reprint.

Monographs

Public Utility Valuation. By John Bauer and Nathaniel Gold. New York, The Macmillan Company, 1934.

Stock Watering: The Judicial Valuation of Property for Stock-Issue Purposes. By David L. Dodd. New York, Columbia University Press, 1930.

Valuation under the Law of Eminent Domain. By Lewis Orgel. Charlottesville, Va., The Michie Co., 1936.

Articles

"The Amount Available for Dividends Where No-par Shares Have Been Issued," by Joseph L. Weiner, 29 *Columbia Law Review* 906–919 (1929).

"Balance-sheet Valuations in German Law," by Joseph L. Weiner, 48 *Journal of Accountancy* 195–206 (1929).

"The Breakdown of 'Present Value' as a Basis of Rate Control," by James C. Bonbright, *15th Proceedings, Academy of Political Science* 75–80 (1930).

"The Concept of Depreciation as an Accounting Category," by James C. Bonbright, 5 *The Accounting Review* 117–124 (1930).

"Conflicting Functions of the Upset Price in a Corporate Reorganization," by Joseph L. Weiner, 27 *Columbia Law Review* 132–156 (1927).

"Depreciation and Valuation for Rate Control," by James C. Bonbright, published simultaneously in 41 *Quarterly Journal of Economics* 185–211 (1927) and 27 *Columbia Law Review* 113–131 (1927).

"Money as a Device for Measuring Value," by Simon H. Rifkind, 26 *Columbia Law Review* 559–587 (1926).

"Payment of Dissenting Stockholders," by Joseph L. Weiner, 27 *Columbia Law Review* 547–565 (1927).

"The Problem of Judicial Valuation," by James C. Bonbright, 27 *Columbia Law Review* 493–522 (1927).

"Progress and Poverty in Current Literature on Valuation," by James C. Bonbright, 40 *Quarterly Journal of Economics* 295–328 (1926). (Confined to valuation for rate-making purposes.)

"Railroad Valuation with Special Reference to the O'Fallon Decision," 28 *American Economic Review Supplement* 181–216 (1928). Simultaneously publ lished in somewhat revised form under the title "The Economic Merits of Origina-Cost and Reproduction Cost," 41 *Harvard Law Review* 593–622 (1928).

"A Survey of the Problem of Valuation," by James C. Bonbright, *20th Proceedings, National Tax Association* 15–25 (1927).

"Theory of Anglo-American Dividend Law," by Joseph L. Weiner, 28 *Columbia Law Review* 1046–1060 (1928), 29 *ibid.* 461–483 (1929), 30 *ibid* 330–358 (1930).

"Two Rival Theories of the Priority Rights of Security Holders in a Corporate Reorganization," by James C. Bonbright and Milton M. Bergerman, 28 *Columbia Law Review* 127–165 (1928).

*"Valuation of Property to Measure Fire-insurance Losses," by James C. Bonbright and David Katz, 29 *Columbia Law Review* 857–900 (1929).

*"The Valuation of Real Estate for Tax Purposes," by James C. Bonbright, 34 *Columbia Law Review* 1397–1438 (1934).

*"Valuation to Determine Solvency under the Bankruptcy Act," by James C. Bonbright and Charles Pickett, 29 *Columbia Law Review* 582–622 (1929), reprinted in 34 *Commercial Law League Journal* 684, 751 (1929).

"Value and Vested Rights," by Robert L. Hale, 27 *Columbia Law Review* 523–529 (1927).

"Value to the Taker in Condemnation Cases," by Robert L. Hale, 31 *Columbia Law Review* 1–31 (1931).

"What Is Fair Value in Taxation?" by Simon H. Rifkind, *19th Proceedings, National Tax Association* 305–313 (1926).

Other publications by members of our staff, while not formal contributions to this research, may be noted for their discussions of value theory: Professor Robert L. Hale's book on *Valuation and Rate Making* (New York, 1918); his portion of Smith, Dowling and Hale's *Cases on the Law of Public Utilities* (rev. ed., St. Paul, 1936); the author's article on "Valuation" in the *Encyclopedia of the Social Sciences;* his monograph on *Railroad Capitalization* (New York, 1920); and his portion of the Minority Report of the New York State Commission on the Revision of the Public Service Commissions Law (Albany, 1930). Professor David L. Dodd is co-author with Mr. Benjamin Graham of a book on *Security Analysis* (New York, 1934), which discusses the valuation of corporate securities. The official

Report on Law and Procedure in Condemnation Applicable to Proceedings Brought by the City of New York (New York, 1932), by Hon. Leonard M. Wallstein, reflects many of the views of Mr. Lewis Orgel, whose studies and services were loaned by the research to Mr. Wallstein for this investigation.

It may be in point to mention the relationship between this study and other studies published under the auspices of the Columbia University Council. That by Professor Adolf A. Berle, Jr., and Dr. Gardiner C. Means, on *The Modern Corporation and Private Property* (New York and Chicago, 1932), raises issues as to asset valuation and security valuation, some of which are discussed here. Jointly with Miss Victoria J. Pederson, Professor Berle also published a book on *Liquid Claims and National Wealth* (New York, 1934), which goes further than we have gone in raising certain implications as to the significance of market values. Professors Robert M. Haig and Roswell Magill are directing a research on the concepts of taxable income, one portion of which has already been published: Magill, *Taxable Income* (New York, 1936). The close connection between the theory of income and the theory of value is well recognized by economists, and the newer study will doubtless clarify many issues inadequately treated in the present work.

So many of the author's colleagues and former students have participated in this study that it is impossible to assign proper credit to each individual.

Without the constant cooperation of Mr. Joseph L. Weiner of the New York Bar, this book could not have been written in its present form. The chapters on the law of damages, on the law of dividends, on suits by dissenting stockholders, on the law of reorganization, and on the valuation of corporate stock under the Federal income tax, are largely based on his studies; and many portions of them have been written by him. His criticisms and suggestions have influenced the entire treatise. At present he is Counsel to the Board of Transportation of the City of New York.

The separate treatise on *Valuation under the Law of Eminent Domain*, by Mr. Lewis Orgel of the New York Bar, forms the basis of the summary of this subject presented in Chap. XVI of the present work. Mr. Orgel is now Assistant Corporation Counsel of the City of New York, in charge of important condemnation cases.

The untimely death of Mr. Charles S. S. Epstein of the New York Bar was a serious loss to the research staff and to the legal profession. A large part of the chapters on tax valuations was prepared by him, as was a portion of our study in the law of damages.

Mr. David Katz of the New York Bar is co-author of the article on "Valuation of Property to Measure Fire Insurance Losses," which is almost completely reprinted as Chap. XV. He also contributed much to the damage study.

Mr. Simon H. Rifkind of the New York Bar, in addition to writing the articles noted above, was a major contributor to the chapters on tax valuations.

Mr. Charles J. Pickett of the New York Bar prepared the material for the article on valuation as a test of solvency, which is now substantially reprinted as Chap. XXII.

The separate volume on *Stock Watering*, by Professor David L. Dodd of the Columbia University School of Business, is the only comprehensive study that has yet been made of valuation for stock-issue purposes. His conclusions are summarized in Chap. XXIII.

Mr. Milton M. Bergerman of the New York Bar is co-author of the separate article on corporate reorganization, which discusses a controversial legal theory mentioned in Chap. XXV. He also contributed to the study of the damage cases.

Mrs. Dorothy Maggs prepared much of the material for the study of public-utility condemnations and for the references to the British condemnation law.

Mr. Warren H. Lowenhaupt of the New York Bar initiated the study of eminent domain, which he was prevented from concluding because of his appointment as secretary to the late Judge Bijur of the New York Supreme Court.

The separate article on "Value to the Taker," by Professor Robert L. Hale of Columbia University, furnishes our analysis of this aspect of the law of condemnation, discussed in Chap. XVI and in Mr. Orgel's book on eminent domain.

Mr. Carlos L. Israels of the New York Bar contributed reports used in the chapters on the law of damages.

Dr. Gardiner C. Means' call to Washington terminated his brief membership on the research staff. But his critical analysis of the chapters on value concepts have led to material revisions in this part of the treatise.

Dr. John Bauer and Mr. Nathaniel Gold prepared the monograph on valuation for purposes of rate control. While the chapters on the same subject in the present treatise (Chaps. XXX and XXXI) present the independent views of the author, they reveal few conflicts on major issues.

Mr. Morton Liftin of the New York Bar participated in the revision of the chapters on property taxation.

Miss Elizabeth Sanford initiated the study of tax assessments under the unit rule.

Mr. Benjamin Goldring of the New York Bar collaborated with the author in completing Chaps. XVII, XVIII, and XIX, on tax valuations.

Messrs. Myron N. Krotinger and Milton Sandberg prepared the material for the sections of Chap. XXV dealing with corporate reorganizations under Secs. 77 and 77*B* of the Bankruptcy Act. They also made valued contributions to Chaps. XIII and XIV, on the law of damages.

The brief acknowledgments that follow by no means adequately express the author's indebtedness to colleagues and other specialists for important advice and criticisms: In accountancy, to Mr. Howell A. Inghram and Professor Roy B. Kester of Columbia University, and to Mr. George O. May of Messrs. Price, Waterhouse & Co.; in appraisal, to Messrs. J. W. Cunningham and L. H. Olson of the American Appraisal Company; in bibliography, to Mr. Walter Hausdorfer and his staff in the library of the Columbia University School of Business; in fire-insurance appraisals, to Mr. H. R. Bassford of the Metropolitan Life Insurance Company, to Professor Ralph H. Blanchard of Columbia University, and to Mr. Prentiss B. Reed of the firm of Wagner & Glidden; in the law of damages, to Professor Charles T. McCormick of the Northwestern University School of Law; in the law of evidence, to Professor Jerome Michael of Columbia University; in the law of real property, to Professor Richard R. B. Powell of Columbia University; in the mathematics of finance, to Professors Harold Hotelling and John A. Northcott of Columbia University; in taxation, to Professors Robert M. Haig, Roswell Magill, and Carl S. Shoup of Columbia University, to Hon. Barnet Hodes, Corporation Counsel of the City of Chicago and former member of the Illinois State Tax Commission, to Dr. Arthur H. Kent and associates in the Federal Department of Internal Revenue, and to Mr. David C. Krakauer and Commissioner Jacob Manicoff of the New York State Department of Taxation and Finance; and in many legal problems, to Professor Hastings Lyon of Columbia University. At the inception of the study, Professor Karl Llewellyn of Columbia University took part in the staff conferences and presented points of view that have been fundamental to the preparation of the entire treatise. To Miss Anna D. Hynd of Columbia University the author is indebted for her able superintendence of the secretarial work.

New York, N. Y., James C. Bonbright.
January, 1937.

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CHAPTER I

THE PROBLEM OF JUDICIAL VALUATION

"'When I use a word,' Humpty Dumpty said, in a rather scornful tone, 'it means just what I choose it to mean—neither more nor less.'

"'The question is,' said Alice, 'whether you *can* make words mean so many different things.'" Lewis Carroll in *Through the Looking Glass.*

"A word is not a crystal, transparent and unchanged; it is the skin of a living thought, and may vary greatly in color and content according to the circumstances and the time in which it is used." Justice Holmes in *Towne v. Eisner*, 245 U.S. 418 at 425 (1918).

An electric light and power company is organized under the laws of one of our forty-eight states for the purpose of constructing and operating a power plant and distributing system. The cash cost of the construction is $10,000,000, against which the company issues $15,000,000 par value of bonds, preferred stock, and common stock.

Several years after the promotion of this enterprise, the State Public Service Commission values the property in order to determine the reasonableness of the rates which are being charged by the company. The commission finds a value for rate-making purposes of $11,000,000, but on appeal the company secures from the United States Supreme Court a holding that the "fair value" of the property is not less than $13,000,000.

While the Public Service Commission has been making the above appraisal, a different branch of the government, the State Board of Tax Assessors, has assessed the property for the purpose of the general property tax. For this purpose, however, the value has been fixed at $8,000,000.

Two or three years later, the public utility runs into financial difficulties, with the result that a receiver is appointed. After a delay of many months, a reorganization takes place by means of a foreclosure of the corporate mortgage. At the foreclosure sale the entire property is sold to the reorganization committee for the sum of $5,000,000, which is the upset price fixed by the court as representing the value of the assets.

As soon as the reorganization committee makes the purchase for $5,000,000, it transfers the property to a new corporation, receiving in exchange an assortment of stocks and bonds amounting to a total par value of $12,000,000. Before issuing these new securities, the committee is obliged to secure the approval of the Public Service Commission, under its authority to regulate all public-utility securities. The approval is given after strenuous opposition on the part of counsel for the cities served by the company and also on the part of a minority of the commission, who insist that the "fair value" of the property is clearly less than $12,000,000.

The final chapter in the history of this company is the condemnation of the property by the state, which takes it over as a state-owned enterprise under its power of eminent domain. The price paid by the state is determined by a jury under careful instructions by the trial judge. A figure of $16,000,000 is awarded, and the award is confirmed on appeal by a higher court.

In the above hypothetical illustration, substantially the same property has been given five materially different values for five different legal purposes: rate making, taxation, upset-price fixation, reorganized capitalization, and condemnation. To be sure, our example is an imaginary one, for we have discovered no actual instance in which the same property has been subject to as many as five reported types of official appraisal. Nevertheless, the illustration hardly exaggerates the wide discrepancies between values actually placed by judges and administrators upon the same properties for various legal purposes. Not all of these discrepancies, to be sure, are attributable to different concepts of value. Some of them may be accounted for by the time factor; as when the first valuation was made during a period of business prosperity, but when the second valuation reflected the depth of a depression. Others may be explained by the fact that the one appraisal includes properties ignored in the other valuation; as where a tax assessment covers only tangible fixed assets, whereas the rate base includes an allowance for going value and working capital. Still other discrepancies may be due to mere differences of opinion or of bias on the part of the tribunals that have made or reviewed the appraisals; as where the tax-assessing board yields to the proverbial tendency to underassess property, whereas the tribunal which determines the condemnation award yields to the equally notorious tendency toward excessive compensation.

But even after giving full weight to all of these factors, we still face the undeniable fact that, in American law at least, both the concepts of value and the technique of its proof are decidedly influenced by the

specific purpose for which the valuation is made. The rulings on admissibility and the judicial comments on the weight to be given to the evidence differ so markedly that they reveal fundamental differences in substantive law—in the very meaning of the phrase "value of the property" as a legal objective.

Twenty years ago, the question whether the legal meaning of value is dependent on the purpose of the appraisal was in hot dispute among lawyers. Counsel for the railroads and for some of the public-utility companies scouted the idea in their briefs in rate cases.[1] It is simply ridiculous, they urged, to suppose that the same property, at the same time, can be "worth" a certain figure for rate-making purposes, another figure for condemnation purposes, and still a different figure for tax purposes. "Value" or "fair value," they asserted, is a definite "fact to be found," not an amount to be determined by reference to the result which the evaluators desire on grounds of public policy. If constitution, statute, or common law requires that railroad rates be so determined as to yield a reasonable return on the present *value* of the property, that mandate predetermines the relevance of original cost, capitalized earnings, and the other symptoms of a high or low value. To be sure, appraisal experts and lawyers may differ as to how value shall be "found" in a specific case; and they may even disagree on nice questions of precise definition of the very word "value." But having once defined value and agreed upon its method of proof, they are not at liberty to go back upon their conclusions by redefining the term in another type of litigation.

Even today, this view that "value means value" persists in arguments of counsel in tax cases, rate cases, and other forms of litigation. Indeed, it is still occasionally expressed or implied in the reported opinions of the courts. But the opposite position, as expressed by Justice Brandeis in his statement that "value is a word of many meanings,"[2] is fast becoming the prevailing one, not only among the legal commentators but also in the appellate courts. And Justice Holmes' classical remark that "a word is not a crystal, transparent and unchanged,"[3] by reference to which he justified a broad interpretation of the concept of taxable income, aptly states the modern view of the related concept of value. Even since this research was begun, in 1925, we have noted a marked increase in the emphasis placed by reported opinions and by law-review articles on the purpose of the

[1] See *infra* pp. 1104–1108.

[2] Southwestern Bell Telephone Co. v. Public Service Commission, 262 U.S. 276 at 310 (1923). See *infra* p. 1102.

[3] Top of p. 3, *supra*.

valuation as affecting the interpretation of the very meaning of "value of the property." On this point, at least, the legal "realists" or "functionalists" seem to be winning their contest against the traditionalists.

But the recognition that the proper meaning of "value" cannot be determined without reference to the purpose of the valuation, merely presents a problem without solving it. For it leaves unanswered the question how value should be construed in any given case. Indeed, unless this question can be satisfactorily answered, the eclectic use of the term "value" may do far more harm than would a rigid use. It will serve as a basis for all kinds of specious claims by litigants that property which has been valued at a high figure for one purpose should be valued at a low figure for another purpose, and vice versa. It may bolster the familiar arguments of public-utility companies and railways in favor of a low tax base and a high rate base; it may support tax assessors in placing arbitrary assessments on property, undeterred by the opportunities of taxpayers to present rebutting evidence of over-valuation; and it may play into the hands of the owners of condemned properties, who seek awards far in excess of appraisals that would be sanctioned by businessmen in voluntary purchases and sales. Those who deny, as we deny, the implications of the statement that, in law, "value means value," are under a heavy obligation to distinguish between proper and improper shifts in its meaning and in its mode of proof.

The present study was undertaken in the hope that it might contribute to an understanding of this problem and that it might stimulate a new interest in the attempt to solve it. With this object in mind, the author and his associates have studied several thousands of reported cases in which the value of specific property has been at issue. Save in a few instances, especially in the field of eminent domain and of utility rate making, we have not looked beyond the reported opinions, to the records of the trial; and this limitation is a serious one. But the larger task was precluded by the wide scope of the investigation. A further limitation has been our omission of various fields of law in which a valuation of property is often required. Thus, in public finance we have not covered appraisal as a phase of special assessments, nor valuations under the protective tariffs; while in insurance we have confined attention to the measurement of those recoverable losses that are insured against under a standard fire-insurance policy. It is believed, however, that our range of cases is wide enough to reveal all the major issues of value theory that have arisen in American property law.

In view of the prominent and vital role played by valuation of property in modern law, it is somewhat surprising to find that no previous attempt has been made to treat the subject systematically, in a single treatise. To be sure, certain phases of the subject have been canvassed at great length—notably valuation for public-utility rate control, on which the literature would fill a fair-sized public library. But in most other fields of law, the appraisal problem has been dealt with superficially, by writers who have been content to quote the reported opinions on the nature and proof of value without examining the statements critically, from the standpoint of an appraiser or an economist.

Doubtless one of the reasons why legal valuation has not been studied synthetically is that the subject does not correspond to the specialty of any single profession or of any one person's career within that profession. The cautious expert fights shy of a problem that involves law, economics, accountancy, and commercial appraisal. Even the lawyer is almost never an expert in "valuation law"; instead he is a specialist in eminent domain, or in taxation, or in corporate reorganization. Even the appraiser is not at home in the whole field of appraisal; instead, he is a real-estate appraiser, a mine appraiser, a security analyst, etc. So with the economist who knows much about public-utility rate making but nothing about eminent domain, or with the accountant who is a specialist in income-tax accounting but who has but slight acquaintance with railroad accounting for rate-making purposes.

The very fact that an intelligent valuation of property is out of the question, without reference to the purpose for which the valuation is desired, indicates that the major task of developing the theory of legal valuation rests with the specialists in those particular fields of legal economics which give rise to the necessity of appraisal. Thus, only the person with a firm grasp of the theory and practice of public-utility regulation is competent to discuss the concept of value for rate-making purposes; while only the expert in public finance is qualified to pass on the proper basis of valuation for tax purposes. But while these specialists should have the last word on the subject, they will be seriously handicapped in their judgments unless they have at their command comparative studies of valuation for various purposes, in which emphasis is laid on the contrasts and similarities between the value concepts applicable to different fields. We have here an example of a point that is fast becoming recognized in the social sciences—the necessity of a breakdown of barriers between the traditional sciences.

It is a striking commentary on the tendency of the social sciences to become overstratified, that the academic economists, who have long claimed the theory of value as their central theme, have given so little attention to the practical problems of appraisal that are constantly arising in business and in law. For the most part, their interest has centered in the forces that are supposed to determine the prices actually fixed by the process of "higgling and bargaining" on the market place. Only a few of them have been concerned with the way in which professional appraisers determine a "fair selling price" in a business negotiation, in the way in which accountants value assets for balance sheets and income statements, or in the way in which courts and commissions value property for legal purposes. Perhaps they have rested under the impression that these practical issues involve merely a mass of detailed technique and of meaningless convention, unsusceptible to analysis by reference to any major principles of economic theory. But in neglecting the field of appraisal, they have missed some of the most important factors in market-price determination, to say nothing of price fixing by legal fiat.

Within recent years the "institutional economists," including persons sympathetic to that method of approach who do not make use of this term, have noted this serious gap in traditional economic thought and have called upon their profession to take more interest in valuations made off the market place by appraisers, accountants, and courts. Thus David Friday appealed for "An Extension of Value Theory" in an article written under that title in 1922.[4] As if in response to this call, Professor John R. Commons published his notable book on *Legal Foundations of Capitalism*,[5] in which he traced the changing concept of property as reflected in the Supreme Court opinions, with the correlative change in the concept of value. More recently he has followed this earlier treatise with a book on *Institutional Economics*,[6] Chap. 10 of which bears the significant title, "Reasonable Value." The present study follows the same line of thought, although it misses the historical emphasis which is such a noteworthy part of Professor Commons' contributions.

As a conclusion to this introductory chapter, a comment on the arrangement of the present treatise may not be amiss. Part I is concerned with the concepts of economic value as developed by the economists and the courts, with incidental reference to the value concepts of the professional appraisers. Chapter II presents a brief

[4] 36 *Quart. Jour. Econ.* 179 (1922).
[5] New York, 1924.
[6] New York, 1934.

survey of important value concepts and distinguishes them from associated concepts, such as those of cost and of utility. Chapter III discusses in detail the various meanings of "market value," while Chap. IV treats at length a concept fundamental to legal appraisal—that of value to a specific owner. Chapter V explains the close relationship between different concepts of property and different concepts of value. Logical considerations would have assigned this last chapter to an earlier place in the treatise; but convenient exposition has led to its being given a deferred position.

Part II is concerned with the methods of estimating or "proving" value, separate chapters being devoted to those types of "evidence"—such as actual sales, original cost, and replacement cost—that are most frequently adduced in litigated cases and most generally used by professional appraisers. The subject, however, is here studied from the standpoint of economic theory rather than of the legal rulings under the law of evidence, since these rulings can best be discussed in connection with valuations for specific legal purposes. Chapter VI introduces this portion of the treatise by noting the effect of the varying concepts of value on the technique of its determination.

Part III presents the case studies, classified by reference to the specific legal purposes for which the valuation is made. Those fields of valuation on which we have published separate monographs (stock watering, eminent domain, and rate making) are treated here in summary form. Even with respect to several of the fields not treated elsewhere, as with income-tax valuations, we have been content with a brief treatment rather than with a detailed analysis of the vast mass of reported cases.

Necessarily the arrangement of the chapters in Part III has been largely arbitrary, since the interrelationships between the different types of valuation are complex and confused. What we have called "the indemnity cases" (damages, eminent domain, fire insurance), clearly belong in a single group, although the valuation of a public utility in a compulsory-purchase case has an important relationship to valuation for rate-making purposes. The valuations for ad valorem tax purposes are also best grouped together; but valuation for income-tax determination belongs in another class, along with valuation to determine income available for dividends. The similarity of proximate functions (determination of income) is more significant than the difference in ultimate functions, although even this latter difference is far from negligible as an influence on principles of appraisal.

CHAPTER II

CONCEPTS OF PROPERTY VALUE

The Definition of Value as an Appraisal Problem.

Valuation, as the term is used in this treatise, means the procedure and technique of estimating the value of specific property at a stated time and place.[1] In a derived sense it refers also to the estimated value itself, as when we say that a court upholds a valuation of ten million dollars placed upon a tract of land by a tax assessor. The word "appraisal" is also used in both of these senses, as an interchangeable synonym for valuation.[2]

What is called "the theory of appraisal" is a systematic treatment of two problems that arise in every valuation of property. The first problem is to secure a definition of "value" acceptable for the purpose of the particular inquiry. The second problem is to determine the method by which the quantum of this value shall be estimated.[3] In

[1] The term is also used in other senses in the social sciences. In modern philosophy it denotes the study of the meaning and significance of "value" in its broadest sense; and in psychology it refers to the processes associated with attraction, repulsion, and choice. Wilbur M. Urban, *Valuation, Its Nature and Laws* (London, 1909); Ralph B. Perry, *General Theory of Value* (New York, 1926). In economic theory it is used, not so often to mean the technique of estimating value, as to characterize the forces that determine prices in the market place. Thus, to the appraiser the problem of valuation would be to determine the value of a particular lot of wheat at a given time and place; but to the economist, the problem would be to explain *why* the wheat is worth, then and there, the amount that the appraiser finds it to be worth. Needless to say, the two problems are related, and their solution calls for a much closer cooperation between the two professions than has yet been forthcoming.

[2] There is a tendency in professional jargon to use "appraisal" to refer to that type of valuation which is based on estimated replacement cost.

[3] These two problems by no means exhaust the questions that must be answered before an intelligent valuation can be arrived at. Three prior questions, among others, must always be disposed of: those concerned with (*a*) the precise nature and extent of the "property" that is to be valued, (*b*) the date of valuation, and (*c*) the place of valuation. In legal appraisals, one or more of these questions may constitute the major contested issues. For example, in the taxation of a railway "property," there may be a hot dispute as to whether the tax base is the physical right of way and equipment, the whole enterprise as a "going concern," or the outstanding securities. In the law of damages, the date as of which the loss shall

legal language, we are concerned both with the "fact to be found" (substantive law) and with the proof of this "fact" (law of evidence). A holding by a court that the owner of condemned property is entitled to compensation based on the *market* value of his property purports to answer the first question, whereas a ruling that a previous sale of similar property is admissible evidence of market value answers one aspect of the second question.

At first thought one might suppose that the problem of defining value is a fairly simple one—or at all events, that it might be settled once and for all by a consensus of those experts who are called upon to pass judgment on property values. The only seriously controversial problem might seem to be that of determination or estimate. Indeed, a scrutiny of the standard books on appraisal would appear to lend support to this assumption. For, as a rule, only a short preliminary chapter—sometimes only an introductory paragraph—is devoted directly to the concept of value itself. The bulk of the discussion is concerned with evidentiary problems—with the choice of a proper *method* of valuation.

Yet, when one reads the conventional value definitions critically, one finds, in the first place, that they themselves contain serious ambiguities, and in the second place, that they invoke concepts of value acceptable only for certain purposes and quite unacceptable for other purposes. Thus, recent writers on real-estate appraisal have defined value in terms of "justified selling price," but with inadequate attention to the question what is meant by "justified." Moreover, little light is thrown on the question whether "justified selling price" is a desirable standard of valuation in each of the many fields of law in which the courts have occasion to place a value upon property.

What has just been said is by no means meant to imply stupidity on the part of the appraisal profession in its failure to make clear its value concepts or to determine their usefulness for specific purposes. Certainly our own study can claim only a limited success in this effort. The point that we are emphasizing is that the problem of defining value, for the many practical purposes for which the term is used, is an exceedingly difficult one, deserving quite as much attention as does the

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be established is frequently at issue, as is the question whether a transportable commodity should be valued at the place of shipment or at the place of delivery.

Narrowly interpreted, valuation theory is not concerned with these questions, the answers to which must be given to the appraiser by his client before his professional task begins. In practice, however, they are so closely intertwined with the problems of defining and measuring value, that they cannot be completely ignored in a treatise on valuation.

technique of proof. In many respects, to be sure, the two problems cannot be divorced from each other. As with other economic terms in practical use (like "income," or "cost"), so with "value," the very meaning of the word is conditioned by the methodology of estimating its quantitative amount. But the definitive aspect should be emphasized quite as much as the probative aspect, and its difficulties exposed to critical analysis.

Value Sometimes Means Any Monetary Statement about Property.

Modern business transactions give rise to an almost endless number of occasions for associating specific objects of property with specific sums of money. When a corporation buys an asset, the purchase price is carefully recorded and is used in the preparation of the balance sheet and the income statement. As the asset depreciates, accountants may make appropriate deductions from its cost price in restating its book value. If the asset is sold, its sale price becomes an important matter of record. If it is to be insured against fire, a "present valuation," based on current replacement cost, may be required. If it is subject to general property taxation, its "assessed value" must be ascertained. If it constitutes a part of the property of a public-utility company, its "value for rate-making purposes" may become a matter of inquiry. If it belongs to a bankrupt company, its estimated "forced-sale value" may be called for. Indeed, it would require many pages merely to enumerate the multitude of purposes for which it may become necessary to couple a particular object of wealth with a given number of dollars and cents.

The answer to the question, what sum of money should be assigned to any given asset, depends on the purpose for which the record or estimate is to be used. Sometimes, the answer can be given without controversy—original cost is clearly required, or current market price is the obvious thing to be recorded. Often, however, a highly debatable issue arises—say as between auditor *A* who believes that good will should be valued for balance-sheet purposes at a nominal sum of $1, and auditor *B*, who would prefer to book the good will at a figure which represents the best estimate of its "real worth." These issues sometimes get into court, as may happen in a case where the legality of a dividend paid by a corporation depends on the value properly ascribed to good will. They thus take the form of a "legal problem," which the judges must settle, partly by reference to statute law or legal tradition, partly by reference to approved business practice as testified to by accounting, appraisal, or economic experts.

When the word "value" is used in its very broadest sense, any one of the many alternative ways of associating items of property with sums of money may be called a "valuation," and the particular figure arrived at may be called "the value of the property" for the purpose of the case. Here we are using "value" as a mere colorless expression for "dollar amount." The accountant who enters the fixed assets of his company on the books at original cost, regardless of subsequent appreciation or depreciation, is "valuing" the property just as truly as is the appraiser who does his best to determine what he would call "present value" as distinct from historical cost. Even the arbitrary $1 value that orthodox accounting convention assigns to good will is just as "true" a value as is the million-dollar estimate which is based on a capitalization of anticipated earning power. Indeed, under this broad definition, there is no distinction between a "true value" and a "false value," unless one uses these terms to distinguish between a monetary figure which is appropriate for the purpose at hand, and one which is inappropriate for that purpose.

Necessity of Restricted Senses of the Word.

To some extent the literature of appraisal, but to an even greater extent the literature of accounting, sanctions the use of "value" in this deliberately question-begging sense. The sanction comes particularly from the more sophisticated modern writers, who deplore the traditional attempts to determine how property should be valued by reference to the silly question, What does value *really mean?* These writers therefore propose to devitalize the word "value," so as to deprive it of that dangerously emotional content which characterizes ambiguous terms of approbation. In rate making, they say, let us ignore the question whether original cost or replacement cost is a measure of "real value" and consider whether either of these two criteria will function well as a rate base. In accounting, let us stop disputing whether the original cost of fixed assets represents "value to the going concern" and discuss only the question whether its adoption for balance-sheet purposes will lead to good or bad social consequences. Call original cost "value" if you like; but don't assume that you have lent the term any dignity by giving it that appellation.

If a deeply rooted linguistic tradition did not stand in the way, the merits of this proposal to deprive the term "value" of its assumed definitive character would be well worth considering. Indeed, the limitations of the English language make this procedure almost essential when "value" is used as a verb rather than as a noun. For we lack an acceptable alternative term by which to describe the act of

valuing an asset at original cost, or of valuing the good will at $1, or of conservatively valuing the property at one-half of its estimated value.

But the complete adoption of this proposal, especially in the law, could hardly be hoped for at this late date. And it is therefore more expedient to recognize that, while "value" may be used to mean any monetary statement about property, it may also conveniently be used to signify a concept, or set of concepts, by reference to which one may distinguish sharply between value and cost, value and utility, value and fair price, value and other related notions. Indeed, unless we use "value" in narrowed senses, it would be difficult to find other English terms by reference to which these important distinctions can be drawn, save equally vague synonyms like "worth."

In the course of this treatise, therefore, we shall have occasion to distinguish between certain judicial valuations of property where the objective is clearly to ascertain value in an appropriate or strict sense of the term, and other valuations where the objective is, quite properly, to "value" the property at something else than its value. Thus, in conformity with the unanimous agreement of economists, we shall recognize valuation of public-utility properties for rate-making purposes as a pseudo-valuation. Certain types of asset valuation for income-tax purposes will also be placed in this category. Indeed, as will be noted in Chap. VI, there are various legal situations where what is traditionally regarded as mere *evidence* of value constitutes a legal standard superior to the value which is assumed to be the ultimate "fact" to be sought for.

The Two Basic Concepts of Property Value: Market Value, and Value to the Owner.

The term "value" in its broadest philosophical sense invokes a concept which can hardly be expressed save by the use of synonyms—that of appreciation, of worth, of favorable importance.[4] In economics, things are deemed to have value for their supposed capacity to perform services,[5] and in that department of economics which is concerned with the value of *property*, things are assumed to have value for their capacity to perform services for those persons who can exploit them by exercising the powers of ownership. As an object of private property,

[4] As here used, "value" must be distinguished from the value concepts of the pure sciences, such as mathematics and physics, which do not attribute human worth to the values of which they make use. The fact that number "5" is a higher "value" than number "4" does not give it a greater utility to any person, not even to the mathematician.

[5] Economic values are *instrumental* values. See *infra* p. 89, note 31.

a house has value only because of its prospective service to its owner as a living place, or else because of the power that its ownership may confer upon the owner to exchange it for money or other property.

To those who accept the above statement of the essence of the value concept, the test of a "true"—that is, of an appropriate—value concept is that it represents worth, or desirability, or desiredness as distinct from other attributes of things or of property rights in things, such as weight, color, cost of acquisition, replacement cost, arbitrarily capitalized earning power, etc. Some of these other attributes, such as original or replacement cost, may often furnish the best practical measure of value. But this very fact makes a distinction all the more imperative, since no one measure is always applicable, and since a fallible measure is in danger of being taken for the value itself.

From what has just been said it would seem to follow that the *value* of property should always be taken to mean value to some specific individual or group of individuals, who have or may have an ownership interest in the thing. A chair, a residence, a railroad right of way, and an electric-light franchise, considered solely as objects of property, have no value except for the advantages that they may confer upon whatever persons may claim a special legal interest in their exploitation through use or sale. But since any object of wealth may be capable of conferring different advantages on different owners—as in the case of a pair of eyeglasses, which is adapted to Smith's eyes, but which would be of no possible use to Jones—one cannot properly speak of the value of a property *in general;* instead, one must speak of its value to some specific person or group of persons. Strictly construed, therefore, property value should mean invariably value to some particular owner.

Much of the literature, both of law and of professional appraisal, is friendly to this restriction of the value concept to that of value to the owner. In many of the reported cases, for example, one finds statements to the effect that the market price or market value of property does not necessarily measure "real value," and that it is usually taken as a basis of valuation only because, as a rule, no more trustworthy measure of this fundamental value is available. "Real value" is often apparently taken as a synonym for the more revealing term "value to the owner."[6]

But in law, as in economics and in business, value is often used in an associated sense, as a synonym for market price or market value. "The worth of a thing, is the price it will bring," in the words of a jingle frequently repeated by judges as well as by economists. When the term is thus construed, no property, however valuable it may be to the

[6] But it is also used by the courts in other senses.

particular individual for whom it is specially adapted, has any *value* unless it can be sold to some other person; and the amount of this value is always determined by the price at which it can be sold. Properties like the New York Stock Exchange building (which is said to be unsalable, because of its peculiar construction) or the Columbia University Library, or a legally or factually nontransferable easement of light, air, and access, would therefore be deemed utterly valueless (save for a possible salvage value), were this concept of value rigidly adhered to.

This identification of value with market price, for which the classical economists are perhaps primarily responsible, does such violence to the spirit of the word that its abandonment might well be urged, were it not too late to hope for success in this direction. But the linguistic tradition is too firmly entrenched to be upset in the interest of scientific terms. We are therefore forced to recognize two distinct though related major concepts of property value, the one referring to sale price, the other referring to value to a specific owner or group of owners. The resulting ambiguity will not be serious if its presence is constantly observed and the distinction, in all its implications, clearly recognized. Such a distinction is generally recognized even today in the law cases, but its full import is not always appreciated. In consequence, the value concepts of the courts betray a tendency to slide over unconsciously from the idea of value as mere sale price to the idea of value as worth to the owner. We stress this point in the next chapter, on market value, where we note the invocation of vague ideas of *fair* market value, or of prices as fixed by mythical willing buyers and willing sellers, which are confused straddles between the two meanings of value stated above.

Later sections of this chapter will present two other concepts of value that are of importance in appraisal and that are appropriately called value concepts: "justified selling price" (often called "intrinsic value") and "normal market value." But since both of them are forms of hypothetical market value and are therefore derivative rather than basic concepts, their discussion may best be postponed. Meanwhile it is important to consider three other attributes of property that should be distinguished from value in *any* nice sense—utility, cost, and fair price.

Distinction between Value and Utility.

A distinction that the economic textbooks have been at pains to make since the days of Adam Smith is that between the *value* of an object of wealth, and its utility or usefulness. Brief discussion of this

point will suffice here, since the implications are now generally recognized.[7]

One of the apparent paradoxes that gave early economists much concern is the relatively slight correlation between the values of different things, in any usual sense of "value," and their utilities. The distinction, as generally made, was between *market* value (more often called "value in exchange") and utility, or (as it was formerly called) "value in use." "Nothing," said Adam Smith, "is more useful than water, but it will purchase scarce anything; scarce anything can be had in exchange for it. A diamond, on the contrary, has scarce any value in use, but a very great quantity of other goods may frequently be had in exchange for it."[8]

It is clear, as John Stuart Mill pointed out,[9] that Smith meant by "value in use," or "utility" as most economists now say, value according to some standard of ethics or welfare distinct from the values that individuals actually attach to the ownership of things; otherwise he would have recognized that the diamond may have a high utility. That is, the possession of a jewel is highly important to many people, and the mere fact that the importance is attached because of love of display rather than because of so-called utilitarian motives does not detract from its quantitative amount.

Even, however, if we modify Smith's connotation of value in use, so as to deprive it of its ethical or utilitarian implications, we still have to account for the striking differences between the market values of various commodities and the satisfactions that they give to their possessors or the desires that they evoke in people who want to possess them. For with all due recognition of the importance that people attach to articles of display, one can hardly believe that many persons would prefer to die of thirst rather than to go without the diamond.

In part, the wide discrepancies that exist between the relative

[7] The fact that the concept of utility does not lend itself to a quantitative expression has prevented it from becoming as serious a source of confusion in practical appraisal as has the concept of cost which, like value itself, may be expressed in terms of dollars. But even the former confusion is sometimes revealed by the legal cases, as where a court points out that an expensively constructed property, though admittedly of little value as a source of profits to its owner, nevertheless has great utility or "use value." See a Wisconsin case discussed *infra* p. 844. In pleading for the acceptance of reproduction cost as entitled to great weight in the valuation of business properties, attorneys sometimes argue that this cost is an index of the high capacity of the property to serve the public. But capacity to serve the public is quite different from the value of property as *property*.

[8] *Wealth of Nations*, Bk. I, Chap. 4. For a judicial reference to Smith's distinction see State v. Yates, 10 Ohio Dec. Reprint 182, 185 (1899), a burglary case.

[9] *Principles of Political Economy*, Bk. III, Chap. 2, Sec. 2.

utilities of various types of wealth and the prices at which units of wealth may be bought and sold, is a phenomenon of our capitalistic system with its extremely unequal division of purchasing power. For example, the fact that a de luxe automobile may have a market value of $10,000, while many people are starving because they cannot buy a sufficient supply of bread, is a result of a distribution of wealth which permits some people to gratify their slightest whims by offers of large sums of money, whereas other people cannot buy the necessities of life.

But the wide rift between relative market values and relative utilities is due only in part to the unequal distribution of purchasing power. It is also to be explained by the peculiar meaning that is attached to the word "utility." When we say that a bucket of water, in a community where water is plentiful, has great utility, we mean merely that it has the capacity to satisfy an important want—say, to quench the thirst of one individual for twelve hours. But despite its "utility" as we are here using the term, a bucketful of water not only has little or no market value but also little or no value to any one individual. For its availability is unimportant to anyone, since by hypothesis there is a free and plentiful supply of other water.

In short, the modern economist's distinction between utility and value is that the former term refers to the mere *capacity* of a thing to perform a useful service, whereas value refers to its importance *in view of that capacity*. The same idea has been put in other words by economic textbook writers who say that a thing, in order to have value, must have both utility and scarcity. If the article is deemed to be useless, people will not want to appropriate it; but even if it has utility, people will not ordinarily value it at more than the cost of securing a duplicate—a cost which is negligible when the supply is plentiful.

A discussion of the relationship between value and utility would not be complete without reference to the concept of *marginal* utility, developed by one important school of economic thought. Brief reference will be made to this concept in the Appendix to Chap. IV.

Distinction between Value and Cost.

From the standpoint of practical appraisal, a distinction of far greater importance than that between value and utility is that between value and cost. Since each of these two terms has different meanings, the interrelationships between costs on the one hand and values on the other hand are highly complex, and we defer a fuller treatment to the

chapters on actual cost and replacement cost as evidence of value (Chaps. VIII and IX). But some broad distinctions should be drawn here, as they are fundamental to a study of the meaning of the word "value."

The contrast between "value" and "cost," as fundamental concepts, is that the former term refers to the advantage that is expected to result from the ownership of a given object of wealth (or to the market price that this advantage will command), whereas the latter term refers to the sacrifice involved in acquiring this object. This distinction is clearly in our minds when we ask whether any thing, or any desirable human achievement, "is worth what it costs." In raising this question, we are striking a balance between the good that will come from securing the thing or doing the act in question, and the sacrifice that must be made in getting the desired result. Cost, then, is the price that must be paid for value, a price which may take the form either of physical or mental pain ("negative value") or of foregoing other positive values ("opportunity cost").

In the valuation of property, cost takes the form of a money outlay incurred in order to secure the property in question, or else of an outlay of property or of labor that may be converted into a money equivalent. Two kinds of costs are distinguished in appraisal cases—costs that were actually incurred by the owner of the property or by some preceding owner in buying or constructing the property; and hypothetical costs that would now have to be incurred in replacing the present property with a substantially identical or somewhat similar property. We may call these costs actual cost and replacement cost, although they are also known by other names.

As a matter of principle, the distinction between either of these two forms of cost and either of the two basic concepts of value is rarely denied in any serious discussion of valuation. Everyone is aware of property which is now worth far less than either the price at which it was originally bought or the cost that would now have to be incurred to secure a duplicate; and this statement is clearly true whether "worth" here refers to market value or to the special value of the property to its owner. The distinction is almost invariably recognized in the law, where the courts have held that value means neither original cost nor replacement cost. Under proper circumstances, to be sure, either or both of these costs may be accepted as legally admissible *evidence* of value; and under some circumstances a court may find, or permit a jury to find, that the property in question was worth on valuation date precisely what the owner paid for it, or precisely what witnesses have estimated as its replacement cost. But

in theory at least, it is nearly always open to a litigant to prove a higher or lower value.[10]

While the possibility of a monetary difference between the value of property and its cost is no longer a controversial issue in the law, if it ever was so in the past, the precise relationship between these two sets of data about property is hotly disputed. Here a distinct rift can be found between the views of most experts in appraisal, and the expressed opinions of the majority of courts. By and large, the courts have been ready to assume a far closer correspondence between the value of the property and its cost, especially its replacement cost,[11] than unprejudiced experts would concede to be warranted, or than intelligent businessmen or investors have accepted as a basis for purchase and sale. For some reason, the fact that a house, or an office building, or a public-utility plant, would be very costly to replace with a substantially similar structure, will usually influence both a judge and a jury in the direction of a high valuation, to a degree to which it would not influence an unbiased appraisal specialist or real-estate dealer. These latter individuals tend to discount cost data heavily, in favor of facts and opinions bearing more directly on the advantage that a person would secure by becoming or remaining the owner of the property. They adhere, more closely than do most courts, to the idea that the value of property is nothing but the value of an opportunity to derive future profits or other services, and that cost is literally irrelevant save for its indirect bearing on this opportunity.

This point will be developed at length in Part II of this treatise, on measures or "evidence" of value. Here we may note that the tendency to overemphasize cost as a measure of value is sometimes due to a recognition by the courts that, for many legal purposes, cost is a better legal standard than value itself would be, could that value be accurately ascertained. In utility rate cases, for example, the *value*

[10] Exception should be made of certain fields of law, notably that of fire insurance, where a statute directs that the property may not be "valued" at *more* than replacement cost. See *infra* pp. 367–368.

[11] Few, if any, reported opinions in the history of American law go as far as does one of the leading recent treatises on real-estate valuation in denying a close relationship between cost and value: Frederick M. Babcock, *The Valuation of Real Estate* (New York, 1932). Babcock writes (p. 36): "There is rarely, in fact, any connection between the cost of replacement of a building and its value." He later presents various qualifications to this statement. The general trend of the profession is distinctly away from reproduction-cost valuations. The most important function of these costs, according to modern appraisal theory, is to set the *upper limit* above which property cannot ordinarily be reasonably valued. See Chap. IX.

of the property does not qualify as a sound rate base. The courts have not quite recognized this economic truth to the extent of abandoning value as the verbal basis of rate regulation. But they have implicitly done the same thing by laying dominant emphasis on some form of cost, original cost or replacement cost, as "evidence" of value. The compromise or hedge is unfortunate, however, for it still leaves unsettled the question as to the nature of this "fair value" that must be proved by rules of evidence not properly applicable to other types of valuation.

One of the frequent sources of legal confusion between cost and value is the tendency of courts, in common with other persons, to think of value as something inherent in the thing valued, rather than as an attitude of persons toward that thing in view of its estimated capacity to perform a service. Whether or not, as a matter of abstract philosophy, a thing has value except to people *to whom* it has value, is a question that need not be answered for the sake of appraisal theory. Certainly, for the purpose of a monetary valuation, property has no value unless there is a prospect that it can be exploited by human beings. If large quantities of oil or coal have been made irrecoverable by wasteful procedures of drilling and mining, these resources have no value even though their existence is definitely established and their ownership by some individual is undisputed. If a house is made permanently unlivable by the presence of noxious fumes from a near-by factory, it has no value as a house, although it may have value to an owner for the purpose of securing an award of damages from the creator of the nuisance.

This is so elementary that it hardly seems worth stating. Yet its implications have sometimes been overlooked by the courts, as is illustrated by the following cases.[12] Some years ago the city of Boston purchased a tract of land under an agreement whereby the owner was at liberty to remove the building thereon within a certain time. After making this agreement, the owner renewed his insurance on the building, which shortly thereafter burned down. The insurance companies objected to paying any insurance, claiming omission by the owner to state material facts; but they further contended that, at most, they should be held liable only for the very low value that a house, doomed either to be abandoned or to be moved elsewhere, was worth. This claim was based on the terms of a standard fire-insurance policy which limits recovery to the "value" of the destroyed structure.

In these cases it was clear from the facts as reported in the opinions that the house was worth to the owner only a small fraction of its replacement cost. It was also clear that the market value of the house

[12] The Washington Mills cases, discussed *infra* p. 393, note 73.

was trivial. Yet, while virtually conceding these facts, both of the courts in which the suits were brought, a Federal court and the Massachusetts Supreme Court, held that the liability of the house to almost immediate removal should not be deemed to have detracted from its value as fixed for the purpose of measuring compensation. The "intrinsic value" or "real value" of the property, they held, was unaffected. In short, the property was thought of as having a value "in itself," somehow associated with its construction cost, but completely dissociated from the functions that it was capable of performing to its owner, or to any other owner. Clear-cut reported cases of this kind are not numerous. But when they arise, they throw much light on the tendency of courts in less extreme cases to feel that, because a building, or a railway right of way, or a public-utility plant would be very expensive to reconstruct, therefore it *must* have a high value even though it promises to yield but little profits or service to its owner. In Chap. V we shall note that this concept of an "intrinsic value"[13] goes hand in hand with the older concept of property, conceived as a physical thing rather than as a group of rights or interests in the thing.

Value and Fair Price.

One of the variant meanings assigned by the standard dictionaries to the word "value" is that of legitimate or fair price, as distinct from an unfair or extortionate price. This special connotation is suggested by the phrase "fair value," which is often used by the courts, especially in utility rate cases, and which seems to imply the possibility of an unfair value which should be disregarded in law even if it concededly exists in fact. Often "fair market value" is also used in the statutes and in the reported opinions, as if to carry notice that the equities and not the bald realities of property values must be taken into account. But even used without adjunct, the term "value" is often taken to import a standard of proper conduct, an "oughtness" rather than a mere "isness," which is foreign to the word as defined by most economic theorists. Ideas of this nature are implicit in statements that a department store is selling its summer hats for more than their value, or that another store is having a bankruptcy sale at which its wares are being offered for much less than their worth, or that the scarcity of maidservants has forced a housewife to pay her cook twice what her services are worth, or that the rates of an electric-light company are much in excess of the value of the service. All of these assertions

[13] Not to be confused with a legitimate concept of "intrinsic value" discussed *infra* p. 24.

invoke some notion of a fair or ethical price higher or lower than the price at which the commodity or service in question is being sold or can be sold.

In the interest of clear terminology, most modern economists have taken strong exception to these implications of the value concept. They have by no means denied that prices may be fair or unfair, and many of them have attempted to determine standards of fairness as well as to suggest practical measures of price control. But in their opinion it obscures the problem to assert that only a *fair* price represents what the commodity is worth and to state that an unfairly high price does not reflect "true value." Like "horsepower" in engineering or "volt" in physics, economic value is a concept that, in the preferred usage of modern economists, carries with it no implications of praise or blame. If, in fact, the owner of a given property could sell it for $10,000, the question whether he *ought* to sell it for only $5,000 has no bearing whatever on what the property is worth.

Unlike the economists, the courts have been far more concerned with reasonable decisions on practical issues than with a nice use of language. They have therefore felt free to import concepts of fair price into their interpretation of value, and to value property at more or less than its worth as defined by economists or as accepted by businessmen in actual transactions. But the resulting confusion in some departments of legal valuation suggests that there is much merit in the attempt by economists to draw a more clear-cut linguistic distinction between value as an existential fact and value as a standard of decent conduct.

The "fair-price" idea arises from time to time in legal valuations for many different purposes. But it is most prominent in public-utility rate cases. In the determination of the rate base, the Supreme Court has never identified value either with the market value of the property, or with the worth of that property to owners. Instead, it has thought in terms of a "*fair* value," which may be much higher or much lower than commercial value, and which is closely associated with the actual or replacement cost of the property. But its failure to indicate the precise difference between this "fair value" and the factual value that supposedly governs a condemnation case or a tax case, has thrown the law of public utilities into serious confusion.[14]

[14] The association of "value" with "fair price" is also found in another aspect of rate making, that which makes use of the principle of "value of the service" as a measure of the rates which a utility or railway company may be permitted to charge. Consumers often argue before regulating commissions that the rates now in force are "more than the service is worth." If they mean merely that the rates

Even in the field of eminent domain, one notes the influence of considerations of fair price, derogating from those of an orthodox valuation. This point is illustrated by a recent opinion of the New York Court of Appeals in the condemnation of an elevated-railway structure.[15] The court sustained an award for the easements of air, light, and access based on the *original* cost incurred by the company in acquiring these rights from adjacent property owners. In form, the problem was to determine "the present value" of these easements; but there was no reason to suppose that this value was measured by original cost, and the court practically admitted as much in justifying the award on principles of "equity."

The Concept of Intrinsic Value or Justified Price.

The preceding sections have explained the two basic concepts of property value, market value and value to the owner, and have distinguished both of them from other related concepts that, for the sake of clear thinking, should not be regarded as value concepts—utility, cost, and fair price. We may now explain two other concepts of value which, though secondary to the two previous ones from the standpoint of logic, are of importance in certain types of appraisal. The first of these concepts, which will now be discussed, is often called "intrinsic value," or "real value." But the terms are unfortunate, not only because they falsely imply that property can have value in itself, without respect to the services that it can perform to persons who may acquire it, but also because they are often used in senses quite different from that now to be explained. Indeed, we have already noted a purely mythical notion of "intrinsic value" in the fire-insurance case in which two courts held that a practically useless building had a high intrinsic value.[16] "Warranted" or "justified" price is a more satisfactory term, and it has been adopted by Frederick M. Babcock in his treatise on real-estate valuation.[17] But "intrinsic value" is still the conventional phrase.

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are so high as to deter consumers from taking the service, their use of the term "value" is accurate. But if they mean, rather, that the consumers are forced to pay extortionate rates because they are in the grip of a monopoly, they are identifying value with "fair price." A monopoly derives its very advantage from its ability to make its service more "valuable" by "artificially" limiting supply.

[15] The Manhattan Elevated case, discussed *infra* p. 427, note 53.

[16] *Supra* p. 21.

[17] *The Valuation of Real Estate*, Chap. 1. A distinction must be noted, however, between "justified price" as a synonym for "intrinsic value," and "fair price" as the term was used in the previous section. When an appraiser refers to the intrin-

The concept is constantly invoked in the fields of stock speculation and investment analysis. Stock-exchange brokers frequently speak of a security as selling for more or less than its intrinsic value, and security analysts regard their central task as one of discovering discrepancies between current prices and intrinsic values. If the security is found to be selling at less than this value, it is held to be a "buy"; if at more than this value, it is a "sell."

What the investment expert means when he says that a given stock or bond is selling out of line with its intrinsic value, is that the current selling price is not justified by those prospects of future yield that are assumed to govern the actions of investors in their purchases and sales.[18] Several different reasons may account for this breakdown of the market as an accurate measure of intrinsic value.

One of them may be illustrated by the example of two bond issues with identical investment merits, the first of which is quoted at several points below the other because it is called a "debenture," whereas the second is called a "mortgage bond." Let us assume that, through the operation of a restrictive covenant, even the so-called debenture is now secured by the very mortgage that serves as a lien for the other bond. Yet this fact may not be known to many investors, who therefore attach unwarranted importance to a name. Hence the market values may differ, though the intrinsic values are identical.[19]

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sic value or justified price of any property, he does not mean to express an opinion on the ethical question as to the price at which the owner, as a good citizen, should be willing to sell the property. He is merely setting a standard of intelligent business conduct and is assuming the ethics of the profit system.

[18] The best discussion of intrinsic value in the investment field is that by Benjamin Graham and David L. Dodd, *Security Analysis* (New York, 1934), Chap. 1. There is no uniform agreement among the experts as to the precise meaning of the term, which is used in different senses for different purposes. Major disagreement concerns the treatment of certain special factors that contribute to the market prices of securities. Shall the value of the stock for purposes of voting control be disregarded? And what about the fact that a government bond may be selling for a premium because it promises its owner complete or partial tax exemption, or that bond *A* has been made legal for trust funds in New York, whereas equally secure bond *B* has been denied this privilege? All these factors bear on the "real value" of the security to specific owners and are properly taken into account by intelligent traders. But one or more of them are *sometimes* referred to as not affecting intrinsic value. Similarly, in merchandise appraisal, a distinction is often made between the intrinsic value of a jewel "as a jewel" and its "sentimental value."

[19] It is a well-known practice in corporation finance to give bonds deceptive titles in the hope of securing higher market prices. Investment writers have frequently called attention to discrepancies in the selling prices of various securi-

Another reason for a discrepancy between market prices and intrinsic values may be illustrated by a security, the price of which is skyrocketed by some form of speculative manipulation, say by the fact that a group of short sellers find themselves caught in a corner and are therefore forced to pay "holdup prices" in order to make delivery without default under the rules of the Stock Exchange. These prices are said not to represent intrinsic values; that is, they do not reflect a fair valuation of the stock as an investment. Here, unlike the situation in our previous illustration, the purchasers are willing to pay more than this value for the shares, not because they are ignorant, but because their peculiar legal exigency makes it imperative for them to have the stock at any price. The special value of the stock to the short sellers is not regarded as an element of intrinsic worth.

Still another discrepancy between current market price and intrinsic value arises when a limited supply of floating stock is in demand by interests who seek to acquire voting control of a corporation. A few hundred shares may spell the difference between a majority and a minority interest, and these shares may be bid for at amazingly high prices by rival factions.

In all of these situations, the concept of intrinsic value differs from that of market value in two respects—first, in that the former value is determined solely by reference to those advantages of ownership that are supposed to be typical of a security issue, namely, the opportunity to draw interest or dividends in the future; second, in that this value is intelligently estimated in the light of all available data and opinions about the security. Thus, the determination of the intrinsic value of a cornered stock requires the investment analyst to ignore the peculiar value of that stock for the purpose of meeting a contractual obligation of short sellers, while the determination of the value of the misnamed debenture bond requires the analyst to use more judgment in weighing the security of this bond than is used on the market place. An appeal is made both from Peter the speculator to Peter the investor, and from Peter the foolish investor to Peter the wise investor.

A similar, possibly an identical, concept of intrinsic value is used by the real-estate appraiser, although this profession is likely to entitle the same concept "fair market value." Most appraisers, when asked to submit a report on the value of real property, do not regard it as their function to estimate the price at which the property could actually be sold, should the owner care to sell it. This function, they believe, is

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ties of a company in default, based on unjustified assumptions that the one security would receive better treatment than the other in the reorganization.

best performed by a real-estate broker, whose attention is directed to the current whims and fancies of the market place rather than to the more enduring merits of the property. As pointed out by one of the ablest writers in the field, Frederick M. Babcock,[20] the appraiser's task is to submit an opinion on "justified price," on the price at which the property may reasonably be sold by reference to its investment merits. It is for him to criticize market conditions, not to accept them on their face; for if he cannot express a better opinion of the merits of the property than that reflected by the average trader, he has no right to advertise himself as a valuation expert.

Here, as in investment analysis, we have a concept of value differing from market value in a strict sense, in that it represents, not what the property could presently be sold for, but what, in the appraiser's judgment, the property *would* sell for, were the market composed of (*a*) intelligent individuals who (*b*) were interested in buying and selling the property only by reference to its investment merits. Often it is called "true value" as distinct from the market prices that are thought of as "fictitious." More properly, it is to be regarded as a *hypothetical* market value, since it represents the market prices that would prevail under conditions other than those that actually exist. But popular thinking, like poetic thinking, is prone to identify the true with the beautiful, and to say that what *should* be the value of the property, *is* its value.

Courts, like the investment analysts and the real-estate appraisers, sometimes make use of this concept of intrinsic value; but the extent of its use in the law is by no means easy to determine. Occasionally judges have stated that the problem at hand is to measure "intrinsic value" or "real" or "true" value, all of which terms are sometimes used interchangeably. But seldom have they defined or explained these terms, and it is not often possible to say just what they mean by them, except that they do *not* mean current market price. More frequently, however, "market value" or "fair market value" is

[20] *Op. cit.*, Chap. 1. See also Babcock's discussion in 1 *Jour. Am. Inst. Real Estate Appraisers* 23 (1932): "The figure we arrive at when we appraise real estate is not market price and is not market value. That is not what we are after. What we are really after is the amount of money which some one is warranted in paying for a piece of property." This same concept of value has been accepted by the Federal Housing Administration for mortgage purposes. See its *Underwriting Manual*, Pt. I, Sec. 2, discussed by Ayers J. Du Bois, "The Valuation and Mortgage Risk Rating Systems of the Federal Housing Administration," 3 *Jour. Am. Inst. Real Estate Appraisers* 324 (1935). Unfortunately, some courts and appraisers call this value concept "market value" or "fair market value," ignoring Babcock's important distinction.

announced by the courts as the normal standard of valuation. These market-value phrases might seem to preclude the acceptance of a value differing from that fixed on the market place, and in fact have been held to do so on many occasions. But the use of that vague, question-begging statement that market value means the price at which the property would be sold by a "willing seller" to a "willing buyer," is suggestive of the concept of intrinsic value.[21]

One of the reasons for the uncertainty of the law on this point is the doubt as to whether intrinsic value, defined as above, is a better basis for the settlement of property rights than would be market value in a literal sense. In many cases it seems more equitable to base a legal valuation on market value even if that value be definitely ascertained as quite out of line with intrinsic value. Consider, for example, a suit by a stockholder against a broker for the conversion of the stock. Assume that the stock has a market value of $100 per share, although its intrinsic value, based on an expert opinion of its investment merits, is but $50 per share. Should the plaintiff be limited to a recovery of this lower sum? The argument to the contrary is that, but for the conversion, the owner might have sold his stock on the market place for $100 per share, and that his ability to do so was in no way impaired by the fact that a buyer would have been foolish to pay that price. The force of this argument is generally accepted in damage law, with the result that the owner may usually recover market value without reference to intrinsic value.

Assume, now, the contrary situation of an owner of property, say land, which is "intrinsically worth" far more than the price at which it could be sold under present market conditions—a discrepancy due, let us say, to a temporary depression in the real-estate market. If this property is condemned, should the owner recover the lower market value or the higher intrinsic value? Orthodox law sanctions the former basis of compensation, and in the typical case this position seems to be sound on the principle of indemnity. During a depression, an owner can usually replace his property with other property at depression prices. He will therefore be fully indemnified if he recovers the market price in time to permit him to buy similar property at less than intrinsic value.

Another reason why the courts have wisely hesitated to make general use of the "intrinsic value" concept is that, even if it were concededly a fairer basis for determining legal rights, it would be

[21] See *infra* p. 59.

extremely difficult to estimate.[22] If the Federal income-tax bureau, for example, were compelled to find the intrinsic value of all stocks and bonds for tax purposes, the administration of the law would become almost hopeless. Endless controversies would arise between taxpayers and assessors, many of which would be carried into the courts. Faulty as is market price as an index of value, it supplies a relatively objective and easily administered basis of valuation that no other method can supply. The most persuasive arguments for the use of the "intrinsic value" standard apply only in those cases where market value itself cannot be inferred from current price quotations, and where controversy as to the value of the property is therefore inevitable under *any* interpretation of the word "value."

The Concept of Normal Value.

Just as it is possible to appeal from the prices that are current on the market place to prices that *would* be current if the market acted intelligently, and thus to invoke a concept of "intrinsic value," so it is possible to appeal from the price at which a commodity is quoted in today's market, to some average or trend of prices over a longer period of time. When this latter effort is made, it represents an attempt to make use of a concept of *normal* value, as distinct from the evanescent values (many appraisal writers prefer to call them merely "prices"[23])

[22] So difficult that, in their *Security Analysis*, Graham and Dodd regard the task as hopeless. "The essential point," they write, "is that security analysis does not seek to determine exactly what is the intrinsic value of a given security. It needs only to establish that the value is *adequate—e.g.*, to protect a bond, or to justify a stock purchase—or else that the value is considerably higher or considerably lower than the market price." *Op. cit.*, p. 18.

[23] A friendly critic warns the author to stress more clearly the disagreement among appraisers as to whether the term "value," even when used without any qualifying adjective or adjunct, imports the idea of a *normal* or an *intrinsic* value. In this treatise we ourselves answer this question in the negative. That is to say, we make no distinction between money value and price, preferring to follow those economists who define market price as market value measured in terms of money. To us an abnormal, or evanescent, or extortionate, or dangerously low market price represents just as true a current *value* as does a normal, or permanent, or fair, or reasonably high market price. Here we follow by analogy the customary usage of scientific language, which attributes just as much reality to an abnormal phenomenon as to a normal one. For example, the current temperature of a fever-ridden patient is just as truly "his present temperature" as is the temperature of a normal man; and the load now carried by a steam engine is none the less its actual load even though it happens to be an overload that could not be long maintained without a breakdown.

that are assumed to be of little practical significance. Something is sought for that corresponds to a mean tide as distinct from a high or low tide, or to the normal horsepower of an engine as distinguished from the overload horsepower that may be developed for short periods or under especially favorable circumstances.

In theory, the distinction between "normal value" and "intrinsic value" is easy to draw.[24] If we say that the "normal value" or "normal price" of a given municipal bond is around par, we mean that during ordinary conditions of the market, the bond will actually sell at approximately its par value. But if we say that the "intrinsic value" of this bond is par, we mean that, in our opinion, the bond may now be intelligently purchased for any market price up to par value, as an investment. We may insist that the bond is "intrinsically worth" only par even though we assume that, for some reason, the market will foolishly persist in pricing the security at a premium.

In a practical appraisal, however, the distinction between "normal market value" and "justified market value" is often academic. That is to say, the appraiser is compelled by the lack of data to assume that the more persistent price is the more "reasonable" one, or conversely that the price which he deems to be more reasonable is the one which is most likely to persist. The basis for this assumption lies in the belief that, while the market goes crazy over short periods of time, it comes to its senses in the longer run. Hence, the fact that a bond has been selling within a price range of from 80 to 85 during the past few months, may be taken as a better clue to "justified selling price" than would the fact that, on yesterday's stock market, the price fell to 75 or rose to 90. And hence, the investment analyst's conclusion that the bond would now be "justifiably" priced at 60 may lead him to infer that the bond will, before long, command a price in this neighborhood, despite the fact that its last sale took place at 70. But the danger of this assumption that long-run prices are sensible prices is well recognized by competent appraisers; and the author is even more skeptical of the

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The position taken here seems to conform to that of most modern economists, at least so far as their position is correctly stated by their formal definitions of "value"; although a recent article by a distinguished economic theorist would seem to imply the contrary: Frank H. Knight, "Value and Price," 15 *Ency. Soc. Sciences* 218 at 222 (with bibliography).

But many, perhaps most, professional appraisers draw somewhat the same distinction that Knight draws between value and price. To them the current market *price* of a commodity does not represent "true value" unless it happens to be its normal, or proper, or "justified selling" price.

[24] But some writers on appraisal theory make no such distinction. Hence, their value concept is unnecessarily hazy.

assumption than are many writers on the stock and commodity exchanges.

The student of economic theory will recognize a similarity between the appraisal concept of "normal value" as explained above, and the concept of "normal price" or "normal value" developed by the classical economists. To this school of theory, "value," used without adjunct, means current market value by very definition, but "normal value" means the price that the actual market value of a given commodity will tend to approximate in the long run, under conditions of perfect competition. This normal price is assumed to be determined by the cost of producing the commodity.

In fact, however, the correspondence between the classical concept of "normal value," and the appraisal concept of the same title, is but superficial. They are alike only in assuming some standard of normality;[25] they differ in that the appraiser does not necessarily assume that this normal price is measured by cost of production. One can hardly speak of the "cost of producing" a government bond; yet the investment experts sometimes refer to the normal price of such a security.[26]

The terms "normal price" or "normal value" are used sparingly in the legal cases or on the statute books. But the idea itself is sometimes implicit in such terms as "real value," "true value," "fair market value," and "intrinsic value." It accounts for the practice of taking a range of market quotations for a considerable period of time before and after valuation date, as the basis of valuation in estate and inheritance taxes. It is a factor influencing the relatively slow changes in assessments of real estate under the general property tax as contrasted with the rapid changes in market price. It is especially prominent in public-utility rate cases, where the courts have said that the reliability of "spot reproduction costs" as a basis of valuation depends on the question whether these costs represent prices prevailing over a considerable period of time, and where the Supreme Court has held that "fair value" must be determined by reference to prices that are likely to be current in the not-distant future.

What may be the proper place of "normal value" in legal valuation is a problem requiring answer to three questions. The first question is whether, under our prevailing economic system, there is any such

[25] Even here they differ in that the classical school regards its normal price as a fair or economically desirable price, whereas the appraisal concept of normal price implies, not that this price is proper, but merely that it is persistent.

[26] For a discussion of the limited practical utility of the classical theory of normal value in the appraisal of property, see *infra* pp. 153–156.

thing as a "normal" or "representative" price, by reference to which one may say that current market prices are normal or abnormal. The second question is whether the technique of appraisal has developed to the point where these normal prices can be determined with sufficient confidence to make them acceptable as the basis for the settlement of property rights. The third question is whether, even though normal value exists and can be ascertained, it constitutes a better legal standard than does some alternative standard, such as market value on the precise date of valuation.

No one of these questions is easy to answer. The first is unanswerable unless more closely defined. Studies of actual market prices make it clear that few commodities tend to gravitate in price to any one point, constant over a long period of time. They also show that prices undergo no such regular, cyclical changes as characterize the tides or other physical phenomena, and hence that there is no "average price" corresponding in significance to "mean tide," or "average yearly temperature in Chicago." Historical price changes form a discouragingly complex jumble of longer and shorter term trends, longer and shorter term cycles, and sporadic shifts unamenable to statistical expressions of regularity. It is the very essence of the price system that prices are "normally abnormal."

But while this fact properly throws suspicion on appraisal concepts of normal value, it does not necessarily imply that they are worthless. Over short periods of time, for example, the prices of specific commodities or groups of commodities can be seen to have jumped in and out of line with the trend of prices during those periods, as have many stocks during days of boom or panic on the stock market, or as have milk and other perishable produce during the days of a strike. There is a generally prevailing opinion, not denied by the price experts, that the market prices of most types of property have been "abnormally low" from 1930 to date, and that they will probably rise in the near future, due either to economic forces or to government action. The economic iconoclast who accepts the full logic of a denial of any distinction between normal and abnormal price has apparently not yet made his appearance among recognized authorities.

The second question, essential to legal and professional appraisal, is whether normal value or price can be determined, even though its existence is not denied. Let us concede, for example, that the current market value of United States Steel common is not the normal value. How, then, shall we estimate this latter value? If by "normal value" we mean some average or typical value over a stated period of time in the past, the problem is not difficult, for we can here make use of a

historical record, available to a court on the date of trial. But if we regard these historical prices as "water over the dam," and therefore conceive normal value as a figure representing the range of prices that will prevail during some period in the future, we are met with the difficulties of forecast. How difficult this task is, will be recognized if we recall that the thousands of persons who undertake it as stock speculators almost invariably lose. Within recent years the courts have attempted it in various utility rate cases, by listening to the testimony of expert witnesses for the companies, who have asserted that construction costs would rise, and of expert witnesses for the consumers, who have asserted that costs would fall or would at least not soon rise. But this incursion of the courts into the realm of wild prophecy cannot be cited as a shining success. On the contrary, it has added to the long-existing confusion as to the measure of "fair value" for rate-making purposes.

During the pending business depression, concepts of normal value, often undistinguished from concepts of intrinsic value, have been stressed as never before in various fields of litigation, by parties who have insisted that property should not be valued at the prevailing low market prices. It is usually assumed that present prices are abnormal, not merely in that they are below those prevailing before the pending depression, but also in that they will again rise to higher levels as recovery gets under way. These higher normal or "real" values, it is constantly argued, should serve as the basis for tax assessment,[27] or for compensation under the law of eminent domain,[28] or as the measure of the deficiency judgment to which a creditor may be entitled on the foreclosure of a mortgage,[29] or as the basis on which securities held by insurance companies and banks should be valued for balance-sheet purposes. In some cases the courts have been influenced by these arguments to the point of finding or sanctioning appraised values materially in excess of current market prices. Sometimes they have stated that prevailing prices do not represent "fair market values"; at other times they have stated or implied that, even if they do measure "fair *market* value," some different type of value is required by the exigencies of the case.

But other courts have held that prices prevailing even during a prolonged depression like the present one, nevertheless represent "market value" or "value" in law. One of the reasons for a reluctance to depart from the verdict of the market place, is the very forcible one

[27] *Infra* pp. 463–472
[28] *Infra* pp. 417–419.
[29] *Infra* pp. 839–848.

that no long-run or "normal" value can be intelligently estimated. It is well enough to say that the prices at which New York City real estate has changed hands during the past year are no indication of "true value," in the sense of such a price as will prevail when the depression is a matter of history. But who can say what these post-depression prices will be? Cautious economists refuse to venture an answer, except perhaps as a mere guess; and if they should attempt an answer, they would be in violent disagreement.

Our conclusions, then, on the second question posed above, is that the attempt to find a "normal value" differing in a specific amount from current market price is extremely hazardous and that it should be limited to those cases where grave injustice would be done by a valuation at current price quotations. Even here, the dilemma can sometimes be avoided by a postponement of the problem of valuation, as has been done by statute law or judicial decision requiring a moratorium on mortgage debts pending the time when more satisfactory measures of the normal values of the property can be secured.

A third question that presents itself, as to the practical use of the concept of normal value, is whether it would serve as a fairer legal standard than would current market value, even though it could be ascertained with sufficient accuracy. Here we have a problem similar to that already discussed in the section on intrinsic value, and one which cannot be solved without reference to the particular type of case to which it refers. Let us assume the condemnation of a tract of land which, on the date of the taking in 1932, had a market value of only $5,000, but which, as the tribunal knows by some miraculous gift of prophecy, will have a market value of $10,000 at the end of the depression, which is also known to be within two years. Is the owner fairly compensated if he receives $5,000 for the property, or may he justly insist on $10,000, or on some slightly lower figure which discounts the normal value of $10,000, for a period of two years? Assuming that the compensation will be paid at once in cash, before the prices of other, similar, property rise to normal again, the owner will probably be in a position to secure equally satisfactory land at $5,000. He will, therefore, suffer no loss by reason of the taking, if his award is confined to current market value.

But other circumstances may arise, even in the law of eminent domain, under which it would not be feasible for the owner to replace his property at depression prices. In these cases, there is some force to the argument for an award based on "normal value." Whether or not the force is sufficient to overrule considerations of expediency in legal administration, and to justify the adoption of special measures of

compensation applicable to cases of this nature, is a problem that cannot be answered by resort to valuation theory.

The need for some concept of normal value distinguishable from current market price has seemed to be most urgent in other fields of law than in those concerned with indemnity or compensation. In general property taxation, for example, the assessed values in some jurisdictions have recently been far in excess of market values, just as they were notoriously below market values before the depression. Taxpayers have been frantically appealing for relief to tax assessors and to the courts; and their efforts have borne some fruit. But, as stated by a New York judge in conversation with the author, if the courts were rigidly to uphold the law as traditionally interpreted, and to require that no property be appraised at prices unwarranted by prevailing market conditions, their action would throw many cities into bankruptcy. A mere increase in tax rates would not always meet this exigency, since constitutional debt limits based on assessed valuations prevail in various states.

Impressed by these emergencies, courts are under pressure to resort to all sorts of talk about normal value, intrinsic value, physical value, etc., in order to sustain tax assessments that will keep the government going, while not *openly* defying the laws which require these assessments to reflect "true values."[30] Much of this talk is nonsense; but the action which it is designed to support may be necessary.

A somewhat similar emergency has been thought to exist in the governmental regulation of banks and insurance companies. Were these companies compelled to express in their financial statements the values of their securities as set by current price quotations, many of them would be recorded as insolvent, or at least as suffering a capital impairment. Official recognition of this fact might call for the cessation of business, and liquidation or reorganization. Yet just such a valuation has been required by statute law, with respect to stocks and certain bonds. Quite naturally, the bank and insurance commissioners have dreaded the consequences, and many of them have therefore sanctioned valuations based on prices assumed to be more "representa-

[30] In tax theory there is force to the argument that the general property tax should often be based frankly on the undepreciated reproduction cost of the property, quite without reference to the question whether this cost measures value. See *infra* pp. 459–460. But the tax statutes call for a determination of "true value," and assessors and courts are therefore impelled to give weight to costs which masquerade under the guise of "evidence of value." Trials of tax cases are full of this obfuscation.

tive," or "normal," than market quotations as of the date of the financial statement.

This practice has been debated at great length by the National Convention of Insurance Commissioners, and the annual proceedings and actions of that body, together with the literature on insurance,[31] constitute the most extensive published material on the subject of "normal value" in security appraisal. Against the objections of a dissenting minority, the convention has given its official sanction to valuations at more than current market prices. More specifically, it has approved alternative bases of valuation, that for Dec. 31, 1931, being the current market quotations as of June 30 of the same year.[32] This particular date was selected, according to a committee report, because the quotations on June 30 happened to correspond roughly to "the average price of stocks and bonds as reflected by the exchanges for a range of five quarterly periods ending Sept. 30, 1931." These figures were taken to represent fair market values on Dec. 31, 1931. While the commissioners of a few states declined to accept the "convention values," most commissions adopted them with or without modification.

It would be easy to ridicule this administrative fiat declaring that prices on June 30, 1931, should be "deemed to be" fair market values in a declining market, 6 months later. Indeed, the fiat *was* ridiculous in that it purported to state what fair market values on this date really were, instead of frankly declaring that necessity required the adoption of arbitrary accounting values not corresponding to market values, or "true values," or any other definable values. Whether or not the actual *decisions* of the commissioners, as contrasted with their obfuscating *dicta*, were fortunate, is a question that cannot be answered until the future history of security prices is told. If these prices soon rise to

[31] See, for example, *Annual Proceedings of the Association of Life Insurance Presidents; Seventy-third Annual Report of the Superintendent of Insurance of the State of New York;* H. P. Dunham, *The Business of Insurance* (New York, 1932); E. W. Patterson, *The Insurance Commissioner in the United States* (Cambridge, Mass., 1927); R. Riegel and H. J. Loman, *Insurance Principles and Practice* (New York, 1929); S. H. Wolfe, *The Examination of Insurance Companies* (New York, 1910). The author is indebted to one of his former students, Mr. Harold N. Schwinger, for a typewritten Master's Essay on "The Valuation of Securities in the Portfolios of Insurance Companies," filed with the Library of Columbia University, May, 1932.

[32] *Proceedings, National Convention of Insurance Commissioners in New York City, December* 8, 1931. See also letter to editor of the *New York Times* by George S. Van Schaick, Superintendent of Insurance of the state of New York, published in that journal on Dec. 11, 1931.

the convention values, and remain at these levels, the fiction will have justified itself.[33] If not, later and more serious insolvencies may result.

Summary.

The notorious disagreements among expert appraisers as to the value of a given property at a given time and place are due not alone to the inherent difficulty of all economic estimates involving prophecy. They are also due to lack of agreement as to the very meaning of the "value," the pecuniary amount of which is the subject of the inquiry. Not only in law, but in business, accountancy, commercial appraisal, and economics, "value," in the language of Justice Brandeis, "is a word of many meanings."[34] This fact in itself would not necessarily have led to serious confusion; for there are many words to which the dictionary attaches plural meanings (like "gross," which has been used in at least ten senses), the definitions of which are so distinct and so obvious in their functional significance that they are rarely confused with each other. But with "value," as with most other popular words used in economics, the various meanings are closely intertwined and

[33] This was the experience after previous periods of low security prices, when various types of average values were prescribed by the insurance commissions—in 1907, 1914, 1917, 1918, 1919, 1920, and 1921. Schwinger, *op. cit.*, p. 36.

It should be noted that, even during assumed "normal" years, the statutes of various states have sanctioned the use of "amortized cost" as the basis of valuation of bonds held by insurance companies for investment purposes. Amortized cost means actual purchase price subject to additions or subtractions for bonds bought at a discount or premium, as the bond reaches maturity. See Roy B. Kester, *Advanced Accounting* (3d Ed., New York, 1933), Chap. 8, or any book on the mathematics of investment. In the valuation of insurance-company portfolios, a special argument in favor of the use of these amortized costs in lieu of current market prices is that, as a rule, an insurance company meets its liabilities from current income, not by liquidation. This argument is more forceful with respect to life insurance than with respect to other forms of insurance, since the disbursements of life-insurance companies are much more predictable than those of other carriers. It has often been said that amortized costs represent the "values of the bonds to the companies" more accurately than do market values, a statement, the inaccuracy of which will be apparent if one considers which of the two values would more nearly indemnify the company for the loss of a bond tortiously converted. In fact, the best defense of the use of amortized costs in accounting is that these costs constitute better bookkeeping figures than do current "values" in any accurate sense of the term. But the old tradition that a financial statement is one which portrays "true values" dies hard.

[34] Southwestern Bell Telephone Co. v. Public Service Commission, 262 U.S. 276 at 310 (1923), discussed *infra* p. 1102.

shade into each other with almost imperceptible gradations. Not only are they difficult to distinguish—the choice of that particular meaning which is most appropriate for a given purpose is often highly controversial.

Aware of the harm done by this highly ambiguous word, with its dangerously emotional content, some of the most analytically minded experts prefer to devitalize it by denying it any significance whatever, save as a name for any quantitative statement about property to which the dollar sign is attached. Indeed, only by so doing can one bring all of the many judicial "valuations" of property into the category of a real valuation. But even if one accepts this linguistic proposal, one must study closely those more definitive concepts of value by which economists, appraisers, and judges have distinguished between the "value" of property and those other monetary records or estimates—such as original cost, replacement cost, and capitalized realized earnings—which are recognized as merely fallible *evidence* of value. These distinctions are important, even though one must recognize occasions where the "evidence" of value is a better basis of "valuation" than would be the "value" itself, could that value be ascertained with accuracy down to the last penny.

This chapter has noted and briefly explained four concepts of value which seem to us to be of outstanding importance in the legal valuation of property: those of (*a*) value to the owner, (*b*) market value, defined as the price for which an owner of the property could sell it, (*c*) intrinsic value, in the sense of "justified selling price," and (*d*) normal market value. The first two concepts are the primary ones, while the latter two are forms of hypothetical market value. No one of the four concepts is itself free from ambiguity. But if the attempt were made to remove all ambiguities by narrow definition, the resulting terms would be appropriate only in a tiny fraction of all the litigated cases.

Our inclusion of market value and its two derivatives among the value concepts is a concession to economic and legal tradition, and is in some respects an unfortunate necessity. The most useful denotation of the term "value," as applied to property, is the favorable importance of the property, as distinct from all other characteristics (such as bigness, cost, color, utility, scarcity) which merely have a bearing on this importance. But the market price of property has been so long identified with value—doubtless because of its close relationship to the importance of the property from the standpoint of owners—that the proposal to deny it the appellation "value" would almost certainly fail to gain much currency. It is therefore more feasible to distinguish two basic concepts—value to the owner and market value.

As to the two secondary forms of market value—"justified selling price" and "normal market value"—nothing more will be said except in those chapters on valuation for specific legal purposes where the courts seem to have made use of the concepts. The terms are necessarily so unscientific that they defy closer analysis save by reference to specific cases. But "market value" and "value to the owner" will repay more study, and their various meanings are considered at length in the next two chapters.

CHAPTER III

MARKET VALUE OR EXCHANGE VALUE

For the purpose of the preceding chapter, it has sufficed to draw certain broad distinctions between four related value concepts, all of which may be contrasted with certain other concepts, like that of cost, which are frequently confused with value. "Market value" and "value to the owner" were given first rank as the two basic terms of appraisal and were provisionally defined, respectively, as the price for which the given property could actually be sold, and the price which measures the importance of the property to any specific owner, present or prospective. But neither of these definitions is adequate; and the present chapter is devoted to an analysis of the meaning of "market value." It will presently appear that market value is itself a seriously ambiguous term, and that even the removal of its ambiguities does not make it so definitive as to preclude all but one answer to the question, "What is the present market value of this property?"

I. Exchange Value as Construed by Economists.

Although the primary concern of this treatise is with definitions of value accepted in the law, these definitions can best be understood by comparing them with those of the economists, who have used the concept of value as the major tool of their profession. The comparison is especially pointed with respect to the term "market value," since law and economics are alike in placing dominant emphasis on this particular verbal standard of valuation.[1] But the question arises

[1] A study of the definitions of market value as used by accountants and appraisers also suggests itself. But neither of these practical professions has taken much interest in nice definitions, and the practice has been to use the term in various senses appropriate for specific occasions. Moreover, both the accountants and the appraisers—especially the latter—have been impelled to adopt the lingo of the courts, even though their better judgment would dictate divergent terms and more clear-cut concepts of value. In accounting, market value has often been identified with current replacement cost, as is usually (though not invariably) the case when the accountant adopts, as the basis of inventory valuation, the rule of "cost or market value, whichever is lower." Among real-estate appraisers, there has been

whether the two professions invariably mean the same thing by the same phrase. That they sometimes do so is suggested by the fact that the courts not infrequently quote definitions by economists in support of their own interpretations of value. But that they do not always mean the same thing will be apparent as the discussion proceeds.

Traditional Preference for Synonym "Exchange Value."

One looks in vain through most of the early English economic treatises for the use of the term "market value." Almost without exception, the older economists chose the alternative phrase "value in exchange" or "exchange value." This is true of Adam Smith and of the so-called classical school that succeeded him. It is also true of Jevons and of the other members of the marginal-utility school. Even the modern textbooks continue to show a decided preference for exchange value, especially in their formal definitions. A glance through the more popular treatises on economic theory, such as those by Carver, Ely, Marshall, Seager, Seligman, and Taussig, discloses many references to exchange value but only an occasional reference to market value. Whenever the latter term is mentioned at all, it is given as a mere synonym for exchange value.[2] No economist, so far as we are aware, would say that a given commodity may have a market value of $15, but an exchange value of $10 or $20.[3]

Possibly the persistent use of exchange value in preference to market value may be due merely to academic tradition. This explanation, indeed, seems plausible in view of the fact that many economists turn to the more familiar phrase of the street when they are writing on

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a tendency to use "market value" or "fair market value" as a synonym for "justified selling price" as defined in the previous chapter, at pp. 24–29. What an economist would call a merely "hypothetical market value," the appraiser calls "real value"; and what the economist would call "actual market value," the appraiser calls "mere price, not value at all."

[2] Thus we read: "Exchange value is often called market value or objective value." Richard T. Ely and others, *Outlines of Economics* (4th rev. ed., New York, 1923), p. 147. This sentence is dropped in the 5th rev. edition.

[3] Professor John Bates Clark distinguishes between exchange value and market value. *The Philosophy of Wealth* (Boston, 1894); *The Distribution of Wealth* (New York, 1899). But Clark does not identify either of these terms with money price. To him, exchange value expresses the utility which a commodity confers upon its owner because of the owner's power to sell it, whereas market value expresses the utility of the commodity to society as a whole—a utility which is measured by current market price. The significance of Clark's distinction depends on his peculiar concept of social value. In our opinion, this concept is invalid for reasons stated by B. M. Anderson, Jr., in his book, *Social Value* (Cambridge, Mass., 1911).

practical problems or for popular consumption. The choice, however, may have some significance as revealing a concept of value which can be expressed more clearly by the adjunct "exchange" than by the adjunct "market." To many people the word "market" connotes a more or less organized body of competing buyers and sellers, such as that which prevails on the stock and produce exchanges and, to a more limited extent, on the over-the-counter market for unlisted securities. If this view of the nature of a market is accepted, it implies that a commodity cannot be said to have a market value in the strict sense unless it is subject to purchase and sale by a fairly well organized group of traders. Many of the types of property which courts have occasion to value, such as the fixed assets of a business enterprise, or real estate, are not dealt in on an organized exchange and can be sold, if at all, only by special negotiations with one or more prospective purchasers. To say that the sales of these forms of property indicate their *market* values, would be inconsistent with the popular concept as to the nature of a market.

The economist, to be sure, has not always adopted this restricted notion of a market. Under the broadest interpretation of the word, only two people, a buyer and a seller, are necessary to constitute a market, although a very "imperfect" one, and any sale of property is a market transaction. One may therefore say that any property, however nonliquid it may be, has a market value so long as its present owner could sell it for a price, however trivial.[4] Perhaps, however, the economist's preference for exchange value is due to his recognition that this broad concept of a market is not generally accepted.

What has just been said should not be taken to imply that the economists deny any practical distinctions between exchange values reflected by the prices fixed in a highly competitive market, and exchange values reflected only by occasional sales. On the contrary, they would no doubt agree with the courts that the former values have a better claim than the latter as a basis for the settlement of a dispute between plaintiff and defendant. But they decline to distinguish these two manifestations of value by calling the one "market value" and the other mere "exchange value," since they can find no precise line of demarcation between the two. There are infinite gradations between the one extreme of a market composed of a single buyer and seller, and the other extreme of a "perfectly" competitive market. Moreover, the latter extreme is never completely realized even in the best organized markets, such as those of the Chicago Board of Trade and the

[4] But the courts seldom construe "market value" in this way.

New York Stock Exchange. The so-called "perfect market" exists only in abstract theory.

Inadequate Attention Given to Definition of Exchange Value.

Because traditional economics has been interested so largely in speculating on the forces which determine the prices fixed by actual purchases and sales, it has tended to identify the value of property with the prices that are determined in this way. In his famous treatise on economics, John Stuart Mill gave impetus to this tendency by declaring, "The word Value, when used without adjunct, always means, in political economy, value in exchange."[5] This precedent has been followed by many subsequent writers down to the present day. Some economists go still further, by declining (while wearing their professional uniform) ever to use the word "value" save as a perfect synonym for exchange value. But the prevailing practice is to set up special warning signals, through resort to adjectives (as in "subjective value," "social value," and "taxable value"), by which to denote the use of the term in a divergent sense.

In view of the acceptance of exchange value as the master concept of orthodox economics, one might suppose that the textbook writers would have devoted long chapters to its elucidation and to a discussion of its indefiniteness and ambiguities. But, like the writers on practical appraisal, most economists have not felt the necessity of any such exposition. A line or two of formal definition, followed by a few paragraphs on the distinction between exchange value and other terms, has seemed to suffice.

The probable reason for this cursory attention to definition is to be found in the very limited scope of orthodox economic theory. Most of the serious difficulties with the concept of market value or exchange value are encountered when one tries to make use of the concept in assigning a value to property off the market place—to property which is not in process of sale and which may not even be offered for sale. These are the conditions which give rise to the problems of professional appraisal; yet they are the conditions to which the economic theorists have given least attention. But even in its own limited field of inquiry, standard economics has not had marked success with its value definitions, since it has frequently presented a formal definition of value to which it declines to adhere in its actual use of the concept. It has defined value in the first of two senses to be noted presently, but has sometimes proceeded to use value in the second of these senses.

[5] *Principles of Political Economy*, Bk. III, Chap. 1, Sec. 2.

First Meaning of Exchange Value: Price for Which the Specific Property Can Actually Be Sold.

In order to emphasize those distinctions in the definitions of exchange value that are of most concern to the practical appraiser, we may ignore other distinctions which are not involved in a monetary valuation of a particular property at a given time. We therefore pass by a distinction frequently made between (market) *value* and (market) *price*. The "value" of a commodity, say some writers, refers to its power to command any other commodities in exchange and may be "expressed" in terms of power to exchange for wheat, for shoes, for musical concerts, or for money. But the "price" of a commodity refers specifically to its power in exchange for *money*.[6] Market price is therefore a name for market value, expressed in terms of money. We may also pass by, as academic for appraisal purposes, a dispute among some economists as to whether value may best be expressed as a "ratio of exchange" or as a "power in exchange." Neither of these two disputes need concern us, since neither of them would suggest that the same property might be worth one figure under one definition, but worth another figure under the alternative definition.

Of direct import in legal appraisal, however, is a distinction between exchange value as referring to the price at which the owner of a given object of property could *sell* it, and exchange value construed in an imputed sense, as meaning the prevailing unitary sale price of the *type* of commodity in question, multiplied by the number of units to be valued. Here we have two definitions that would often lead to two very different valuations of the same property at the same time. Indeed, the courts have actually faced this situation in litigated cases.

The first of the two definitions is the more conventional one in textbook economics. It is illustrated, with variations, by the following typical quotations from distinguished authors.

> The value, that is the exchange value, of one thing in terms of another at any place and time, is the amount of that second thing which can be got there and then in exchange for the first. Thus the term value is relative, and expresses the relation between two things at a particular place and time.
>
> Civilized countries generally adopt gold or silver or both as money. Instead of expressing the values of lead and tin, and wood, and corn and other things in

[6] It would confuse the discussion of appraisal theory to enumerate the many distinctions that economists have drawn between "value" and "price." One frequently observed distinction, which we do not adopt, has been noted in Chap. II, p. 29, note 23. But Fetter finds 117 separate definitions of "price" in the textbooks. Frank A. Fetter, "The Definition of Price," 2 *Am. Econ. Rev.* 783 (1912).

terms of one another, we express them in terms of money in the first instance; and call the value of each thing thus expressed its *price*. . . . [7]

The value of a commodity means in economics its power of commanding other commodities in exchange. It means the rate at which the commodity exchanges for others. . . .

By the price of a commodity is signified the amount of money which it will command; in other words its value in terms of the accepted medium of exchange.[8]

Value is the power which an article confers upon its possessor irrespective of legal authority or personal sentiments, of commanding, in exchange for itself, the labor, or the products of labor, of others.[9]

From the point of view, at least, of a person interested solely in determining the *money* value of a specific property, these three definitions seem to differ only in form and not in their intended meaning. That is to say, the verbal differences do not justify the conclusion that a given property might be worth $1,000 under Marshall's definition, $1,200 under Taussig's, and $1,500 under Walker's.[10] All of them agree that the value of a commodity is its power in exchange for other commodities, and all agree that this power, when measured or expressed in money, is synonymous with market price. From a logical point of view, Marshall's definition is the least satisfactory; for, taken literally, it would seem to imply that the value of a commodity *is* the physical thing for which it can be exchanged. This violates the accepted notion of the nature of value, which regards value as an attribute or quality of an object rather than as an object itself. Taussig's definition is preferable in this respect, although a captious critic might insist that a commodity does not possess power to exchange itself. Walker's definition attempts to avoid this objection by assigning the power to the person who possesses the commodity rather than to the commodity itself.

[7] Alfred Marshall, *Principles of Economics* (6th ed., London, 1910), p. 61.

[8] Frank W. Taussig, *Principles of Economics* Vol. I (3d ed., New York, 1922), pp. 111–113.

[9] Francis A. Walker, *Political Economy* (New York, 1886), p. 5.

[10] Taussig's above-quoted sentences, however, contain an ambiguity that is fairly prevalent in the writings of economists as well as in the opinions of courts. His first sentence indicates that the market value of a given commodity, in terms of money, is measured by the price for which an owner of the commodity *could* sell it; but his second sentence implies that market value is measured by the price at which the commodity *actually is* sold. These two things may differ. People don't always sell their commodities for the highest possible price. The most obvious illustration of a contrary practice is that of retail stores that cut prices on standard goods in order to attract customers.

Walker's qualifying phrase "irrespective of legal authority" was apparently intended as a safeguard against the inference that the low price at which the law may require a person to surrender his property willy-nilly (as in the case of a public-service corporation which is forced to supply service to all persons who demand it at stipulated prices) reflects the market value of the property. But there is an objection to this qualification; for the sale price of a commodity in a so-called voluntary sale is a price which the seller would ordinarily be unable to secure unless he possessed the legal authority to refuse to transfer the property except on his own terms.[11] Few economists, therefore, have accepted it.

Walker's further qualification, ruling out personal sentiment, is apparently designed to preclude the assumption that the low price at which the owner of a commodity may be willing to sell it, because he is favorably disposed toward the buyer, in any way measures the market value of the commodity. This qualification, however, is redundant under Walker's own definition; for he has already indicated that the value of a commodity expresses the *power* which its possessor has to exact commodities in exchange. If the owner of a house *can* sell it for as much as $10,000, the mere fact that he is willing to sell it for $5,000 has no bearing on its value. On the whole, Walker's definition, bereft of its qualifying phrase, is the most satisfactory of the three, and it has not been improved on for appraisal purposes by any other formal definition that has come to our attention.

Second Definition: Current Market Price per Unit, Multiplied by Number of Units Included in the Property to Be Valued.

Common to all the definitions cited in the previous section is the assertion or implication that the monetary value of any given property is measured by the price for which this property could actually be sold by the person who now owns it, or who has the legal power to sell it, to some other person or persons who are ready to buy it. This may not be the intended meaning of the writers who used the quoted language; but the words seem to carry this construction. Indeed, it is the definition of market value which seems to the author most useful in legal appraisal.

But when so construed, the term "market value" carries implications which not all economists, and not all judges, have been willing to accept. For it requires an admission that the market value of any given property—say an ownership of 100,000 shares of common stock,

[11] For a keen discussion of this point, see Robert L. Hale, "Coercion and Distribution in a Supposedly Non-coercive State," 38 *Pol. Sci. Quart.* 470 (1923.)

or the outright ownership of a large business enterprise, or a holding of ten million bushels of wheat—is dependent to an important extent on the amount of the commodity subject to the valuation. If the owner of a large block of stock tries to sell it on the market place, he is likely to fail to make a sale save at a material discount from the prevailing market price of ordinary 100-share lots. The market will not readily absorb such a large supply. Sometimes, however, the reverse situation is true—the large block of shares may be sufficient to carry control, and its sale may therefore be negotiated at a price materially above the current market quotations for ordinary lots. In either event, there may be a wide rift between the price at which the owner of the property could sell it, and its value as derived mathematically through a multiplication of current sale prices per unit of ordinary lots, by the number of units in question.

Recognizing this distinction, some economists who choose their terms for the purpose of making them amenable to statistical treatment have arbitrarily defined value as price per unit multiplied by the number of units of the (type of) commodity subject to valuation. For them, the value of the 100,000-share block of stock is finally determined as soon as one correctly ascertains the prevailing market price per share, and accurately multiplies this price by 100,000. Similarly, the value of all the wheat in the United States may be ascertained by multiplying the prevailing price quotations for spot wheat of different grades by the number of units of each grade in the nation.

Among the American economists, Irving Fisher has placed this construction on the term "value." Thus, after defining price as the quotient of two quantities exchanged for each other (in fact or in contemplation), he proceeds to define value as follows:

> Having obtained the *price* of any kind of wealth, we may compute the *value* of any given quantity of that wealth without necessarily supposing that particular quantity to be exchanged. The value of a given quantity of wealth is found by multiplying the quantity by the price. Thus, if the price of wheat is ⅔ of a dollar per bushel, then a lot consisting of 3000 bushels would have a value of 3000 times $⅔ or $2000. In other words, the value of a certain amount of one kind of wealth is the quantity of some other kind for which it would be exchanged, if the whole amount were exchanged at the price set upon it.[12]

Fisher recognizes that his definition of value "departs somewhat from economic usage," although he believes it to be in conformity with the usage of businessmen and practical statisticians. But he might

[12] *The Nature of Capital and Income* (New York, 1906), p. 13.

have gone further, by pointing out that many economists who have defined value in the different sense indicated in the preceding section, have at times departed from the logic of their own definition in favor of Fisher's definition when referring to the value of large aggregates of wealth. Certainly Fisher's definition is the accepted one among statisticians who have attempted to determine the value of a nation's entire wealth, or the value of its entire wheat supply or of its aggregate of railway properties.

The identification of the value of any given property off the market place with an amount determined by the current sale prices of units of similar property traded in on the market place, is so frankly arbitrary that it would be beside the point to argue whether or not it is a "true" definition of value. In the field of appraisal, our own preference is for the definition given in the preceding section, which is adopted throughout this treatise save when an alternative meaning is specifically indicated. What Fisher calls "value" we shall designate "imputed market value."[13]

But the important practical question is that of the functional significance of an appraisal reached mechanically by a multiplication of unitary selling prices. This question, in turn, can be answered only by reference to the specific use for which the valuation is designed. Whether or not a census of national wealth, based on a summation and multiplication of the prices of small exchanged quantities of this wealth, has any significance whatever is a debatable question which need not be discussed here, since it seldom if ever has arisen in legal valuations. But the distinction between mathematically imputed market value and actual realization value has frequently been raised in legal disputes and is reflected by two distinct judicial concepts of market value, similar to the two concepts just noted. The point will be mentioned below, in the division of this chapter on the *legal* interpretations of market value.

Neither of the Two Rival Definitions of Exchange Value Precludes Different Valuations of the Same Property at the Same Time.

We must now note that, even if economists were in agreement in their choice between the two above concepts of exchange value, there would still be room for wide disagreement as to the meaning of the phrase "value of the property." Even if value is interpreted to mean the price at which the property in question can actually be sold, there remain many questions, quite unanswered by the conventional definitions, as to the conditions and terms of the assumed sale. On the other

[13] This term is suggested by Richard T. Ely and others, *Outlines of Economics* (4th rev. ed., New York, 1923), p. 177, in a section probably written by the late Allyn A. Young.

hand, if value is taken to mean a mere imputation to the property in question of the unitary selling prices of similar property on the market place, we are left with the necessity of choosing the most "representative" sales, of deciding between sales in a wholesale market and sales in a retail market, of determining what blocks of units (such as 100-share lots versus 10-share or 1000-share lots) shall be taken as setting the relevant unitary price, and of answering the question how closely "similar" the marketed properties must be in order to serve as an index of the value of the property that is being appraised but not marketed.

In the author's opinion, the "imputed-price" definition of market value has such a limited significance for legal appraisal that a general discussion of these difficulties of application would hardly be worth while. But the more orthodox definition, by which the market value of a given property is taken to mean the price at which it could be sold, is of great importance in the law, and its indeterminate nature may therefore be considered at some length.

Time for Negotiation of Sale Unstated. When the economists first developed their concept of market value, they were thinking primarily of commodities such as grains, stocks, or merchandise at a county fair, in which any individual trade takes place quickly, with no serious loss of time between the offer for sale and the consummation of the transaction. In these cases, it takes only a little abstraction from reality to visualize the entire procedure of the sale as taking place instantaneously. Market value was therefore conceived of as the price at which the owner of the property could sell it immediately, whenever he desired to do so.

But suppose that a court must find the value of a residence property, and that it accepts market value, as defined by most economists, as the proper basis of valuation. The owner of the property presents qualified experts who testify that he could have sold it, after a "reasonable" time for negotiations, for $20,000 in cash. The opposing party offers equally convincing evidence that, if the owner had attempted to sell the property precisely on valuation date, he would have been unable to get more than $10,000 for it, because he would have been compelled to make a "forced" sale.

It is true that the courts would have no difficulty in deciding an issue of this kind when presented in so clear a form; for they have interpreted market value to connote such a price as could be secured in an "ordinary" sale rather than in a "forced" sale—in a sale where the vendor has a fair opportunity to "go shopping" for his buyer. But if a court were to rely entirely on the economists' definition of market

value, it would get no instruction whatever on this point. Value is defined simply as power to command a price, not as power to command it only after a decent interval of time has elapsed between the owner's decision to sell and his conclusion of the sale. By this definition, a forced sale, or its converse, a holdup sale, reflects market value just as truly as does any other sale.

Exact Time of Delivery and Payment Not Stated. Because economic theorists have been usually interested only in grand generalizations about the major forces that determine prices, they have properly ignored those minor differences which are due to terms of delivery of the property and of payment therefor. They have pictured the seller of a commodity as transferring it to the buyer with one hand, while receiving the money with the other hand. This, indeed, is about what actually happens in a retail store that is making an over-the-counter sale for cash.

But in the valuation of property for the purposes of a lawsuit, these relatively minor differences cannot always be neglected. This is obviously the case where there is a long delay between the time when the sale is made and the date of delivery or of payment. A wheat future ordinarily sells for a materially different price from spot wheat; and a house sold on credit (with a mortgage to the vendor) may bring a considerably higher price than the same house sold for cash in 3 days. Yet all of these different sales prices would qualify equally well as market values, under the economists' definition which identifies value with power in exchange.[14]

Even the ordinary sales that we think of as cash transactions frequently involve an interval of time between sale and delivery or payment, sufficiently significant to influence the sale price. On the New York Stock Exchange most sales are made for "regular delivery," which means delivery and payment a day or two afterwards. A sale for "cash" (delivery and payment on the same day) calls for a special transaction, and is generally made somewhat above or below the current regular quotation, depending on the question whether the buyer or the seller makes the special stipulation.

When courts face problems of this nature, in interpreting the meaning of "market value," they often select the nearest equivalent to an

[14] We may ignore here the further indefiniteness of the term "market value," even when stated in terms of money, resulting from the fact that money itself is an ambiguous term. In the United States, legal tender or its equivalent is the standard accepted by the courts. A problem of this nature does arise, however, when the United States courts must pass on a question involving foreign exchange. See our supplementary article, "Money as a Device for Measuring Value," by Simon H. Rifkind, 26 *Col. L. Rev.* 559 (1926).

immediate delivery and cash payment that accords with usual practice. For example, they would be likely to accept a sale for "regular delivery" on a stock exchange as a reasonable measure of the value of a security on the date of that sale, preferring it to a sale "for cash" as this term is used by Wall Street. With respect to real property, they generally assume a "normal" cash sale rather than a sale on a partial-payment basis on the one hand, or a sale for payment within 2 hours on the other hand. Their holdings on this point are very reasonable; but they could not possibly be derived by deduction from the formal definitions of market value.

Type of Owner of the Commodity Not Stated. Suppose that an appraiser is called upon to find the market value of fifty shirts, Manhattan brand, in New York City on June 1, 1931. The shirts are turned over to him so that he may observe their style, quality, and condition, but no further information is given him, save for the instruction that he must observe the definitions of market value given in the current textbooks on economics.

The appraiser would have to reply that the question is unanswerable in its present form. For no statement has been made as to whether market value means the price for which the shirts could be sold by their manufacturer, by a dry-goods wholesaler, by a retail haberdasher, or by a retail customer. Yet these price differences are so great that one price may be several times another price. "The power of a commodity to command a price" depends, not alone on the commodity, but also on the market for that commodity commanded by the owner. In this respect, too, market value is indeterminate.[15]

The courts have not had such an easy time with this problem as they have had with the problem of the "forced-sale" price. This is true because the courts have sometimes been uncertain whether to accept the price in the market in which the owner of the property would *replace* it, or its price in the market in which he would *sell* it. We therefore defer discussion of this point for a later section, on the legal definitions of market value.

Market Value as Defined Does Not Indicate What Pressures the Buyer and the Seller May Bring upon Each Other in Their Bargaining Process. We have already noted Walker's attempt to improve on the traditional definition of exchange value by ruling out, on the one hand, sentimental considerations which might cause a buyer to pay more or a

[15] Walker's definition makes the term more definite in this respect by implying that the market value of a given commodity (say, a particular pair of shoes) at a given time means the price at which the commodity could then be sold by whatever person then has the legal power to sell it.

seller to take less for a commodity than would be necessary; and by ruling out, on the other hand, legal coercion as a factor in the determination of the price. Reasons have already been given for rejecting these qualifications and for preferring, in this respect, the more conventional definition.

But even the conventional definition has its difficulties when it implies that *any* power which a commodity confers upon its possessor to exact a price for it, should be taken into account in an estimate of market value. Ordinarily we think of this power as being due to the desire of a prospective purchaser to secure the beneficial use of the commodity over which the owner has legal control. A grocer, for example, owns a loaf of bread. This loaf is coveted by a housewife, for eating purposes. In order to secure lawful possession of the goods, she must tempt the grocer with an offer of some other commodity, a sum of money, which he wants more than the particular loaf of bread. The market value of the bread is therefore thought of as a resultant of the coercive powers of housewives to withhold their money from grocers, and of the coercive powers of grocers to withhold their bread from housewives. Only such powers, however, as are due to the ownership of the bread on the one hand and of the money on the other hand are recognized as determining market value. If the grocer should hold up his customer at the point of a pistol and force her to pay a dollar a loaf for the bread, the transaction would not be regarded as reflecting market value.

Suppose, however, that the owner of a powerful but scandalous newspaper desires to sell his enterprise to a wealthy man, and resorts to a threat of editorial blackmail if his prospective customer will not buy him out at a fabulous price. In this case, the factual power of the newspaper owner to resort to blackmail is due to his ownership of the very commodity, the newspaper enterprise, which he offers for sale, and it could therefore not be ignored if one were to accept literally the definition of market value that has been given by the economists.

Suppose, however, that we attempt to rule out this type of coercive power by stating that only *lawful* forms of coercion may be taken into account in an estimate of market value. We are still faced with the difficulty that there are some forms of coercion which, on the one hand, are lawful, and, on the other hand, are not dependent on the desire of a buyer to secure the property for his own use. The owner of a vacant tract of land, for example, may be able to exact a high price for it because of its so-called "nuisance value" to an owner of adjacent property, who fears that an unsightly building may be constructed upon it. The owner of a business enterprise may sell it to a com-

petitor who has no use for it except to kill off actual or potential competition. In each of these cases, the power of the owner to sell his property depends, not on the purchaser's desire to make beneficial use of it, but rather on his desire to prevent it from being put to harmful uses by other people. And yet, these harmful uses may be entirely lawful and may not even be condemned by current business ethics.

We surmise that most economists would regard the high prices which property may command because of its nuisance value or of its competitive menace, as reflecting the market value of the property, no less than does the price which a householder pays for bread reflect the market value of this food. But the point is not discussed in the books on economic theory, and one looks in vain for a precise distinction between coercive powers that are included and coercive powers that are excluded in the implied concept of market value.

Market Value May Mean Either Gross or Net Sale Price. When the classical economists developed their concept of market value, they had in mind a trade in which the owner of the commodity and the owner of the money did their own buying and selling by going to a market place and by higgling with each other over the price. They were doubtless aware that many sales were not actually made in this way. Certainly, the great classical economist, Ricardo, could not have been under any such illusion, since he himself was a stockbroker. But they were interested in the larger aspect of the problem of prices—in such questions as how the price of wheat is affected by a protective tariff, or how the annual rents of land are affected by the growing population of the country. They therefore took no pains to distinguish between the gross selling price of a commodity and the lower net price which the owner of the commodity would receive after the deduction of broker's charges and other costs. In consequence, their formal definitions of exchange value do not expressly state whether it refers to gross price or to net price.

In economics, however, as in business it is customary to use "market value" or "exchange value" in the sense of full sale price without deduction of selling expenses. Courts have also tended to disregard selling expenses when they are inconsiderable in amount; at least they have not generally deducted them from gross sales prices in arriving at what they call the market value of the property. Thus, in the valuation of real estate for purposes of condemnation or of taxation, hypothetical selling commissions to real-estate brokers are not usually deducted. This practice may be explained either by the fact that courts refuse to go into the niceties of a valuation which is necessarily subject to a large margin of error, or else by the fact that they adopt

market value, not as a means of determining the liquidation price of the property, but rather as a rough measure of the value of this property for the owner's continued use. In damage cases involving the valuation of merchandise in the hands of a retailer or a wholesaler, the courts have usually interpreted market value as meaning the merchant's replacement cost rather than his selling price. One reason which they have assigned for rejecting selling price is the fact that it would over-indemnify the owner of the goods, since it does not involve a deduction for selling expenses. To be sure, they might have taken *net* selling price, but this would have involved the difficult question of determining the precise selling expenses applicable to a specific sale of commodities.

II. Market Value, or Fair Market Value, as Construed by the Courts.

In order to understand the various ways in which the courts interpret the term "market value," one must first bear in mind the variety of uses that they make of it. These uses are almost as numerous as are the types of litigation which call for a valuation of property. In certain kinds of cases, to be sure, the courts have adopted some other standard of value than market value. For example, in utility-rate cases, the Supreme Court, at least, has never stated that "the fair value of the property used and useful in the public service" means market value. The same refusal to accept a market-value test is often found in the valuation of the assets of a business enterprise for purposes of determining annual income. Even in stock-watering cases, where a valuation is placed upon property acquired in exchange for corporate stock, most courts have held or implied that market value is inapplicable with respect to the fixed assets. It remains true, however, that in a surprisingly wide range of cases, differing not only as to the nature of the lawsuit, but also as to the type of property involved, the courts have held either that market value is itself the desideratum, or else that it is persuasive evidence of the so-called "real value" of the property, which is the thing to be ascertained. This statement is notably true of the valuation to measure damages, fire-insurance losses, compensation under the law of eminent domain, and assessments under the general property tax. Often, as in the case of taxation, the common-law tendency of the courts to use "market value" whenever possible is supported by the language of the governing statute, which requires an appraisal based on "market value," "fair market value," or some such synonym.

In view of this marked tendency of common law and statute law to apply a verbally uniform standard of valuation to very different kinds of property and very different types of cases, one can easily understand

why the courts have not pinned themselves down to a precise definition such as that which has been attempted, with only partial success, by the economists. Assume a case, for example, where real property must be valued for the purpose of compensating the owner from whom it has been taken by power of eminent domain. The price which the owner of that property could have secured for it in an actual sale, under conditions of the market prevailing at or about the time when it was condemned, may fall far short of indemnifying the owner for the loss of his property. For example, this price may have been depressed by a temporary panic in the real-estate market, during which the owner would have refused to make a voluntary sale of his property. Again, the sale price may have been much below the owner's reasonable withholding price, because the property was peculiarly adapted to his own use. An award of mere sale value to an owner of such property would result in the grossest form of underindemnity.

If an economist were acting in the role of a judge and were called upon to decide valuation cases of this nature, he would probably prefer to keep to his traditional definition of market value, which identifies it with the price at which the owner could actually sell the property under prevailing market conditions, but to hold that in this particular instance the award should be based on some other figure. The courts, however, are deterred by their legal tradition, and to some extent by statute, from meeting the difficulty in these words. They therefore tend to construe market value in some hypothetical sense, and they arrive at somewhat the same results which the economist would reach by using terms such as "normal value," "fair price," "value to the owner," or "intrinsic value."

Innumerable definitions and discussions of market value are to be found in the reported opinions of the British and American courts. Many of the relevant quotations will be given throughout this treatise in connection with the particular type of lawsuit to which they were applied.[16] The reader may also consult *Corpus Juris*[17] under the headings "value," "price," "market value," and "market price," for an extensive selection of definitions and distinctions. Numerous quotations, however, of judicial utterances are apt to be more confusing than enlightening; and we shall therefore attempt to interpret, in our own words, the more important distinctions in the usage of the term "market value."

Before drawing these distinctions, however, we must note the proneness of the courts and the statute drafters to use the phrase "*fair*

[16] See index, under "Market value."

[17] 38 C. J. 1260. See also Bouvier's *Law Dictionary*.

market value" instead of the simpler term "market value." The addition of the adjective confuses "value" as a merely existential, and perhaps highly unfortunate, fact, with "value" as a reasonable or just price. It might seem to imply that a particular commodity may have a "fair market value" of $100 although its *actual* market value is $80 on the one hand or $120 on the other hand.

It is quite true that the courts have sometimes rejected "the verdict of the market place" on the ground that the prices fixed thereon do not reflect "*fair* market values." Rarely, however, have the judges drawn the sharp distinction between "market value" and "fair market value" that this rejection would seem to imply. Instead, they have more frequently used the two terms as exact synonyms, holding that even the unqualified phrase "market value" must be interpreted to mean "fair market value." To be sure, in cases where they have desired to find a value obviously divergent from current market price, they have justified their action, whenever possible, by stressing the language of a statute calling for an appraisal at "*fair* market value." But even if the statute refers merely to "market value," they have held that the attribute of "fairness" must be imported into the term. Consequently, no reported opinion coming to our attention has stated that the "fair market value" of a given property, at a specified time, is more or less than its "actual market value." Here, as elsewhere in the law, one finds no such attempt as scientists make to distinguish between actuality and desiredness or normality.

First Sense: Price Which the Property Would Actually Bring if Presently Offered for Sale, with Reasonable Time for Negotiation.

Some courts have apparently construed market value in substantial accordance with the orthodox definition of economists. That is to say, the value of a given property is taken to mean the highest price for which the owner could sell it, under prevailing conditions of the market. As a rule, the courts that accept market value in this sense take pains to add that a "reasonable" time for negotiations must be allowed, so as to exclude mere "forced-sale" price. They do not assume, however, the existence of a mythical willing buyer, nor do they identify current market value with such a price as could be obtained under *normal* market conditions, not prevailing on valuation date. The two following legal definitions are illustrative:

> Best price the owner could obtain after reasonable and ample time.[18]

[18] People v. Dowd, 118 Misc. 588 at 589, 194 N.Y. Supp. 3 at 4, (1922).

Price that he [the owner] could obtain after reasonable and ample time such as would ordinarily be taken by an owner to make sale of like property.[19]

Second Sense: Valuation Based on Current Market Prices of Substantially Similar Commodities.

The courts, like the economists, have sometimes used market value in an imputed sense, although they rarely think of the valuation as being an imputation. That is to say, they have imputed to the property in question the unit prices at which substantially identical or very similar property is currently sold or has recently been sold in regular transactions and in customary amounts.[20] A valuation so made may give a very different figure from one that is based on the previous definition of market value. For example, the price at which an investment trust could sell 100,000 shares of a particular stock which it holds in its portfolio, even with due allowances for a reasonable time within which the liquidation must take place, might well be far less than the imputed value of that stock based on current quotations of 100-share lots. If a court applies its first definition of market value, it must make an allowance for what is called "blockage"; whereas, if it applies the second definition, it need pay no attention to the fact that an actual sale of the property in question might greatly depress the current prices prevailing on the market place.

These contrasting concepts of market value are illustrated in an early New York case dealing with the valuation of the Jay Gould estate for inheritance-tax purposes.[21] Under a statute specifying "fair market value" at the time of the testator's death, the appraiser valued several very large holdings of railway securities at the prices at which ordinary lots of these same issues had been traded in on the Stock Exchange. The executors and trustees of the estate objected on the ground that the testator's large holdings—ten million dollars of bonds in the case of one issue—could not have been sold except at a material discount from quoted prices. In upholding the appraiser, the court called attention to a clause in the statute calling for a valuation of property "customarily bought and sold in open markets in the City of New York" by ascertaining the range of prices "through a reason-

[19] Little Rock Junction Ry. Co. v. Woodruff, 49 Ark. 381 at 390 (1887). Quoted with approval in San Diego Land, etc., Co. v. Neale, 78 Calif. 63 at 68 (1888).

[20] For various reported opinions to this effect, see 38 C. J. 1262, especially notes 34, 36, 37, 38, 40, 41, 43, 44, 45.

[21] Matter of Gould, 19 App. Div. 352, 46 N. Y. Supp. 506 (1897), discussed *infra* p. 716.

able period of time." One judge, however, dissented, saying that the reference to current quoted prices should be construed as controlling only when there is a market for securities in the quantities held by the estate.

Another illustration of the use of market value in an imputed sense is to be found in the valuation of public utilities for rate-making purposes. In these cases many courts have said that the land owned by the utility, and used and useful in the public service, shall be valued at "market value."[22] But by "market value" they have not here meant the price at which the particular land could be sold, for they have based the values of railroad rights of way on the current sales prices of *adjacent* land. It is obvious that the long strips of land on which the railway tracks are laid would be unsalable at the prices at which neighboring lots are sold. The courts have simply made an artificial imputation of the sales prices of adjacent lots to the peculiar property owned by the railroad companies.[23]

As a matter of clear terminology, the language of those courts which say or imply that the market value of any given holding of securities or of land is represented by the sales prices of physically similar property, may well be criticized. But in certain situations, the actual decisions of the courts to accept current selling prices as the value "for the purposes of the case" may be defended. In the case of the Gould estate, for example, the refusal of the court to accept plaintiff's claim for a lower valuation may have been justified, partly on the ground that the liquidation price of unusual large security holdings is very difficult to establish, and partly on the ground that the securities may well have been worth to the legatees of the estate far more than the low prices which they would have commanded if dumped onto the market. It is indeed possible that they were worth to the legatees, for purposes of control, *more* than the prices at which smaller lots had been selling. But that point, too, would have been difficult to prove, so that the compromise accepted by the court was a reasonable one. A similar compromise may perhaps be defended with respect to the valuation of railway land for rate-making purposes. The price at which the railway might have sold its land to farmers would clearly be unfairly low;

[22] *Infra* pp. 1141–1142.

[23] Note, also, that in adopting current selling prices of adjacent land, the courts have thereby refused to accept either the price at which the land under valuation could be *sold* by the railway company, or the price at which it could be *bought* by the company (replacement cost). The latter cost would probably be well in excess of sale prices of adjacent land, owing to the unusual expenses of purchasing or condemning lands for public use.

the price at which the land might have been replaced by exercise of the power of eminent domain would have been too high, as giving the railway company a fortuitous "unearned increment" not enjoyed by other landowners.

Third Sense: Hypothetical Sale Price as between a Willing Buyer and Willing Seller.

We come now to a concept of market value which, instead of being borrowed from the economic textbooks or from the language of the street, seems to have been created by the law. Here, as elsewhere, the value of the property is pictured in terms of an exchange transaction. But the exchange is not necessarily assumed to take place at the price for which the present owner could actually sell his property, nor even at the price at which similar commodities are being sold on the market place. Instead, it is such a price as would be realized on the hypothesis that the owner of the property is a "willing seller," and on the further hypothesis that this owner could find a "willing buyer." Especially in the valuation of real property, the courts have constantly invoked this "willing-buyer, willing-seller" notion. The precise form of words has varied from case to case; but the following three examples are fairly typical, and no really significant variations have come to our attention.

We think the court should have told the jury substantially that the measure of damages for the taking of the strip of land in question was its fair market value; being that sum which the owner who desired to sell, but was not compelled to do so, would take for it in its present condition, and what a purchaser who desired to buy, but was not compelled to have it, would give for it under the circumstances.[24]

The market value means the fair value of the property as between one who wants to purchase and one who wants to sell, not what could be obtained for it under peculiar circumstances when a greater than its fair price could be obtained nor its speculative value; not a value obtained from the necessities of another; nor, on the other hand, is it to be limited to that price which the property would bring when forced off at auction under the hammer. It is what it would bring at a fair public sale when one party wanted to sell and the other to buy.[25]

The "market value" of a commodity, in its last analysis, means the price which it will bring in cash from a buyer who is willing to pay its value.[26]

[24] Calor Oil & Gas Co. v. Franzell, 128 Ky. 715 at 735, 109 S.W. 328 at 333 (1908).

[25] Kansas City, Wyandotte & Northwestern R.R. Co. v. Fisher, 49 Kan. 17 at 18, 30 Pac. 111 (1892).

[26] Parish v. Yazoo, etc., R. Co., 103 Miss. 288 at 294, 60 So. 322 at 323 (1913).

There has been much discussion in the cases as to the precise import of these phrases, which require a jury or judge to *assume* a willing buyer and willing seller. A critic of this traditional jargon may raise the point that willingness to buy and sell is a matter of degree and depends in large measure on the price at which the sale shall take place. This difficulty seems to have been recognized by the last-quoted judge; for he defined a "willing" buyer as a buyer who is willing to pay the *value* of the property. But this attempt to give precision to the phrase simply impales the court on the other horn of the dilemma, for it runs into a vicious circle. It makes market value depend on a hypothetical sale, and it makes the price at this sale depend on an assumption of the very figure which is to be found, namely, the value of the property.

As a matter of fact, the cases disclose two very different interpretations of the willing-buyer, willing-seller verbiage, although many of the reported opinions leave one in doubt as to which of the two is accepted by the judge who uses the phrase. The first interpretation is that the court is merely guarding the jury against the acceptance of "forced-sale" prices, and possibly also against the acceptance of "holdup" prices and "boom" prices. With these qualifications, however, the court is still seeking the price for which the present owner of the property could really sell it, rather than the price for which he would be able to sell it if he could find some buyer who does not exist in fact. When construed in this way, "market value" is not clearly distinct from the same term as defined on page 56.

The second interpretation of "willing" buyer and seller goes much further, in that it *assumes* a market that does not really exist. It implies that property which is peculiarly adapted to the uses of its present owner, and which is therefore actually unsalable except perhaps at a very low figure, may nevertheless be deemed to have a high market value. In this case, one must assume the existence, contrary to the facts, of some person other than the present owner, for whose uses the property is adapted, and who is therefore willing to pay a correspondingly high price for it.

When a court adopts this second version of the willing-buyer standard, it is resorting to a *tour de force* by which to bridge the gap between the realization value of a property and its value to the owner. In extreme cases, market value thus becomes a mere synonym for value to the owner. More frequently, however, the two ideas are confused rather than identified; for the courts still make a distinction without indicating its precise nature. They leave a jury uninstructed as to just how far it may go in assuming that the hypothetical willing buyer

is willing to pay such a price for the property as the owner might reasonably pay if he were buying it, or as the owner might reasonably take if he were asked to sell it. This confusion is extremely unfortunate. It would be far better if courts were to restrict the application of the market-value test to those cases where they desire to award the owner of property no more than the price for which he could actually sell it if given a reasonable time for negotiations. Where they do not wish to do this, as in cases where realization price does not even approximate the value of the property to its present owner, they should frankly adopt some other standard of value, such as value to the owner,[27] instead of attempting to make the market-value test fit the case by all sorts of artificial and indefinite assumptions as to a fictitious willing buyer.

In short, we are convinced that the willing-buyer, willing-seller incantation is a great bar to clear thinking in the law, and that it has no more place in legal opinions than it has in the literature of economic theory. In the words of Judge Rose:

> The effort is to find out not what a real buyer and a real seller, under the conditions actually surrounding them, do, but what a purely imaginary buyer will pay a make-believe seller, under conditions which do not exist. You are forced to wonder what would have happened if everything had been different from what it was. It is not easy to guess what will take place in Wonderland, as other people than Lewis Carroll's heroine have found out.[28]

Fourth Sense: Cost of Replacement through Purchase on the Market Place.

In damage cases, particularly, one of the most serious ambiguities of the term "market value" lies in the fact that it has been used to mean sometimes the price at which the owner could sell the property, sometimes the price at which he could buy it. A retail merchant, for

[27] Further study leads the author to qualify this statement. He still believes that, in most legal appraisal, the value of the property to its instant owner, could it be estimated intelligently, is a much fairer basis of valuation than market value in any accurate sense of the latter term (see, for example, *infra* pp. 448–449). But the practical objection to its adoption as the verbal legal standard is that inexpert tribunals tend, almost invariably, to overestimate its amount. See the chapter on eminent domain (Chap. XVI), p. 449; also the concluding chapter (Chap. XXXII), p. 1187. Recognition of this point perhaps explains the position taken by a recent British report on valuation under the laws of compulsory purchase, expressing preference for the scientifically absurd standard of market value as fixed by a willing buyer and willing seller, as against the theoretically far sounder test of value to the owner (*infra* p. 449, note 89).

[28] McGill v. Commercial Credit Co., 243 Fed. 637 at 647 (D. Md., 1917). See also Judge Learned Hand's ridicule of a "willing-buyer" test, in Helvering v. Walbridge, 70 F. (2d) 683 at 684 (1934), quoted *infra* p. 1017, note 67.

example, sues a wholesaler for breach of a contract to deliver a shipment of goods that the merchant desired for his Christmas sales. The court holds, as a matter of law, that the amount of damages shall be based on the "market value" of the goods at the stated time of delivery. The plaintiff argues that market value is measured by retail selling prices, while the defendant argues that it is measured by current wholesale prices. These two figures will differ widely, to the extent of the markup for retail goods of this type.

The economists' standard definition of market value would require a ruling for the plaintiff on this issue, although it leaves unsettled the question whether or not gross or net selling price shall be accepted. But the courts are more interested in a just decision than in an adherence to nice definitions; and in damage cases they have therefore construed market value usually to mean replacement cost in the market, but sometimes to mean realization price. On the whole, their decisions have been based on a desire to give the plaintiff approximate indemnity; and they have recognized that in certain cases replacement cost, and in other cases selling price, is the better standard for reaching this end. The language of some of the reported opinions, however, is unfortunate, because it seems to make the question turn on the "real" meaning of market value, rather than on the particular construction which should be placed on the term in view of the uses to which it is put. Some judges, indeed, have clearly recognized this situation by stating that "market value" or "market price" has no one legal meaning and must therefore be interpreted in accordance with the legal purposes for which it is being used. An English judge, for example, once stated that, in determining market price, "You have always to ask yourself, 'What market?'"[29]

Fifth Sense: "Justified Selling Price" or "Normal Selling Price."

In the preceding chapter, the concept of market value was contrasted with two distinguishable but closely related value concepts—"intrinsic value" ("justified selling price"), and "normal price." Thus, the fact that a certain bond might have been sold at par on Sept. 1, 1934, means that its market value on this date was par, although an investment analyst might conclude that it was "intrinsically worth" only 90 as an investment, and might also report that 95 was its "normal" (that is, its usual) market price. "Market value"

[29] Cherrington & Co., Ltd. v. Wooder [1914] A.C. 71 at 84. See also McGarry v. Superior Portland Cement Co., 95 Wash. 412 at 414, 163 Pac. 928 at 929 (1917). But some courts have asserted that the meaning of market value is plain and definite! See quotations in 38 C. J. 1262, notes 27–31.

itself imports no idea either of a justified price, or of an enduring price, and the ridiculously inflated prices prevailing during a boom, like the panicky prices prevailing during a depression, are just as true market values as are the prices that are supposed to reflect both normal conditions and intrinsic values. One of the most *true* things about market values is that they are likely to be crazy values.

What has just been said about market value applies to the concept as defined by the academic economists. But it does not always apply to the concept by the same name as developed by the courts. Since, by long-standing tradition, the courts are prone to hold that market value constitutes the kind of value applicable to the case at bar, they are under an impulse so to construe it as to make it serve as an equitable measure of the claims of the litigant parties in that case. Accordingly, one finds the judicial concepts of market value colored by vague notions of "justified" or "normal" value, of such prices as are supposed to prevail in an *intelligent* market, or in a market free from the marked abnormalities of a panic or a boom.[30] Thus the relatively sharp distinctions which we have drawn between market value, intrinsic value, and normal value merge into the legal concept of a fair market value, which is likely to be not quite "fair" on the one hand, and not quite "market" on the other hand, but something in between the two.

Among certain writers on appraisal theory, there is a proneness to overstate this tendency of the courts to depart from current verdicts of the market place in favor of more sensible or more enduring estimates of value.[31] The fact is that many, perhaps most, courts are chary of this practice, especially with respect to securities and other properties that are actively traded in. Even in real-estate condemnations, the cases holding that boom-price or depression-price values are nevertheless "true market values" are probably as yet more numerous than are the contrary holdings.

Yet the idea of a normal or an intrinsic value, as implicit in the term "market value" itself, is found in much of the law on valuation of property; and its presence in a disguised form is a source of much confusion to the professional economist, who reads the cases with an "a-moral" and "non-normal" concept of value in mind. A recent holding by the Supreme Court speaking through Justice Butler illustrates the confusion.[32] This was a case arising under the Lever

[30] See, for example, Strong v. Rogers, 72 F. (2d) 455 (1934), *cert. denied*, 293 U.S. 621 (1934), discussed *infra* p. 1032.

[31] Thus Frederick M. Babcock assumes a general acceptance by the courts of the appraiser's concept of warranted price. *The Valuation of Real Estate* (New York, 1932), p. 15.

[32] Highland v. Russell Car & Snow Plow Co., 279 U.S. 253 (1929), discussed *infra* p. 1158.

Act, in which the Court sustained the action of an administrative board, taken during the period of American participation in the World War, in compelling a seller of bituminous coal to reduce its prices. The Court remarked that the prices fixed by the coal administration were not below the "value" of the commodity in question, and therefore that they did not result in a taking of property without due process of law. To an economist, the undisputed fact that the coal producer was able to command a higher price for his product than the one which was fixed by government fiat, is sufficient to show that this latter price was less than the current market value of the coal. But for some unstated (though perhaps quite justifiable) reason, the Court believed that the lower price fixed by the government was fair, or normal, or in the public interest. It therefore held that this price was not less than "value." If the Court had found otherwise but had nevertheless sustained the action of the government, it would have been obliged to admit, what its more conservative members are reluctant to admit, that the government may regulate prices in such a way as to destroy or impair "values."

Conclusions.

The fact that "value" itself is a word of many meanings is now generally recognized in the law as in other professions, and is indicated by the judicial use of adjuncts distinguishing between "market value," "value to the owner," "real value," "intrinsic value," "physical value," "replacement value," etc. What is less frequently recognized, however, is the fact that even "market value," or "exchange value," is a multi-significant phrase, requiring much closer definition than it has generally received in order to constitute even a tolerable standard of legal appraisal. Even the economists have not agreed upon its meaning, while to the courts it has been taken to mean, on occasion, almost anything that the unadorned word "value" might mean.

According to the formal definitions of most economic textbooks, the market value (usually termed the "exchange value") of any object of wealth is measured by the amount of money for which the wealth in question could actually be sold. As to the conditions under which the assumed sale would take place, most definitions are silent; hence the market value of any given property is indeterminate without reference to stipulated conditions. But some economists prefer to use (market) value in an imputed sense, to mean an amount arbitrarily determined by multiplying the price of some conventional unit of a given commodity, as fixed on the market place, by the number of units of that commodity represented by the wealth to be valued. This definition,

like the more usual one, is not sufficiently determinative to preclude many possible answers to the question, What is the present market value of this property?

Our own preference, at least in the field of appraisal, is for the previous definition of market value, under which a valuation of property means merely an attempt to estimate the price for which the property could be sold by some stipulated seller to anyone else the conditions of the assumed sale being left for selection by reference to the purpose for which the valuation is being made. So defined, market value will not qualify as a basis of legal appraisal save in a rather limited number of cases. But no alternative definition of value will serve as a jack-of-all-trades. The use of "market value" as the verbal basis for settling all varieties of legal disputes represents a uniformity of mere words rather than one of principle.[33] The multiformity of value standards is only concealed, not avoided, by the accepted legal definition of market value as the price at which the property would be exchanged between a "willing buyer" and a "willing seller."

[33] Only by reference to this specious uniformity can one assert, as does an eminent writer on eminent domain, that "value," when used as a legal measure of compensation, *always* means market value. Philip Nichols, *The Law of Eminent Domain*, Vol. I, (Albany, N.Y., 1917), p. 658.

CHAPTER IV

VALUE TO THE OWNER

Despite the variety of meanings that are attached to the term "market value," the essence of the concept lies in its reference to the exchangeability of the property as the test of value. A transfer of ownership is assumed, and value is determined by the price at which this real or imagined transfer takes place.

This very characteristic of market value means that the concept has but a limited usefulness in the valuation of property. For if it were invariably accepted as the basis of an appraisal, it would require a finding that many properties, highly prized for the special purposes for which they are designed, are of trivial value because only the present owner is in a position to exploit them. Many of the so-called "service properties,"[1] such as churches, schoolhouses, college campuses, and expensive mansions would fall into this category, as would properties of all kinds that are made unsalable by legal restrictions, such as by entail or by a contractual restriction against the sale of corporate stock. In the same class would belong properties that cannot be effectively used save in conjunction with the owner's other properties—for example, a railway right of way which can be operated only by the owner of the franchise, or a railway terminal that is useless to any other railroad than the one which it now serves. Even many types of *marketable* property are likely to be salable only at a "sacrifice" price which ignores special adaptability to the present owner, as in the case of an ordinary residence which the owner has planned to suit his tastes, and to which he has adapted his own habits of living. Were such a residence to be appraised merely at the price which the owner could induce someone else to pay for it, the appraised value might seriously understate what the property is worth to the owner himself.

Of course, the mere fact that a given property may be worth to its owner more than its market value, does not alone compel a conclusion that the former value should be accepted and the latter value rejected in every legal case in which a valuation is required. In many situa-

[1] An appraisal term referring to properties that are valued for other services than for their money income. Applied particularly to real estate.

tions, market value may be a sufficiently close index of value to the owner to warrant its adoption as a hard-and-fast legal standard; its greater ease of ascertainment may overcome the objections to its niggardliness. In still other situations, market value may be a fairer basis of valuation than would value to the owner, even if the latter could be estimated with equal accuracy and convenience. In certain kinds of taxation, for example, the argument has been made that value for tax purposes should not exceed the price which the owner could realize for his property, since only by selling it could he secure the funds necessary to pay the tax. Questions of this nature are reserved for later chapters, on valuation for specific legal purposes.

But it is clear that courts, like appraisers and accountants, cannot *always* be content with a valuation based on sale price. That they do not thus restrict themselves is indicated by their use of terms like "real value," "fair value," "true value," and "value to the owner." Even more frequently, as noted in the previous chapter, they distort the meaning of market value itself so as to turn it into a rough measure of value to the owner. We must therefore develop this latter concept of value at length. The task is more difficult than that of defining market value, since the economic and appraisal literature has given amazingly little attention to the subject. The courts have seldom attempted a precise definition, and the economists have not often even mentioned the term, to say nothing of analyzing its implications. Accounting writers have made use of an apparently synonymous phrase, "value to the going concern"; but in practice they have usually identified this value with original cost minus allowances for depreciation. The appraisal profession has concerned itself largely with modified concepts of market value, such as "intrinsic value" or "justified price," or else with terms, such as "sound value" or "physical value," that confuse the idea of value with the idea of cost.

Value to the Owner a Form of Subjective Value.

The essential distinction between value to the owner and market value is that the former represents a state of mind, a favorable attitude of a particular person or group of persons toward the thing valued. To be sure, the same characteristic has often been attributed to market value, by persons who say that the market price of a commodity reflects the collective judgment of buyers and sellers as to what the property is really worth. But only in a very limited sense, and with respect to restricted types of property, is this latter assertion valid. Market price is the resultant of bids and offers from many individuals

who place their own valuations on the commodity; but this resultant does not record any community judgment on value, since the individuals who demand and supply the commodity base their valuations on their own comparisons between what the commodity is worth to them and what a given amount of money is worth to them. The fact that a certain automobile has a market value equal to that of 1,000 bushels of wheat does not mean that people, in general, appreciate these two things in the ratio of 1,000 to 1. It merely means that the one commodity happens to command 1,000 times the price that the other commodity commands. Any further conclusions as to the significance of relative market values must be based on inferences that are valid only under certain circumstances.

It is this basic distinction between value to the owner and market value that has led some economists to speak of the former as "subjective value" and the latter as "objective value." But value to the owner is only one type of subjective value, namely, that type which is applicable to the valuation of *property* interests in things. Even in economics and in law, many things are recognized as having a value to people who, in no customary sense of the word "owner," may be said to own them. The Pennsylvania Railroad has value to millions of shippers and consumers who do not own a single share of stock or a bond in the company. A convenient hotel may have great value to its patrons, no less than to its stockholders and creditors. In a Robinson Crusoe economy, things would have value to Crusoe despite the complete absence of property rights; and even in our own society, unlawful possession may give value to objects independent of any rights of ownership, or even despite opposing rights of lawful owners.

Some of these nonownership values of things can be expressed in terms of money, as might the value of a hotel to a patron who would give $100 to prevent it from being demolished. Other things, like the sun, the law of gravity, the heritage of Richard Wagner's musical compositions, and the ingrained habit of Americans in turning to the right when they drive an automobile, may not be amenable to a money valuation. The sun cannot be valued in money, since no amount of money would recompense any group of persons for the loss of its benefits; the habit of turning to the right could hardly be valued in dollars, since its importance could not be measured in quantitative terms.

Perhaps it is true that most non-property values are not measurable in money, while most property values are thus measurable. But under some circumstances, some forms of property are also unamenable to a monetary estimate of value to the owner, as would be a temporarily

irreplaceable bottle of essential medicine at a critical moment in the life of a patient. Its loss or destruction might mean loss of life, and owners of property do not often place a money value on their lives. The essential distinction, therefore, between value to the owner and other forms of subjective value lies, not in measurability in terms of money, but in the fact that ownership values are values that cannot be fully enjoyed without benefit of those legal powers of control and exclusion that we associate with the rights of property.

If this were a treatise on the whole subject of economic value, it would be necessary to treat at length the concepts of nonownership values, with special reference to the notion of social or community value as distinct from mere private or acquisitive value.[2] But as our study is confined to the valuation of property, this far more fascinating and important problem must be ignored.

"Owner" Used in Broad Sense.

The special usefulness of the concept "value to the owner" lies in the distinction which it draws between what a property is worth to a specific individual or group of individuals, and what it is "worth" as meaning its sale price. One finds it convenient, therefore, to give the word "owner" a broad interpretation, so as to make it cover any person whose beneficial interest in an object of wealth is thought of as an ownership interest. Neither legal title nor actual possession need be assumed, although the value of the property to a person who has title or possession may be different from its value to someone else whose claim upon it is of a different nature. It is also convenient to apply the term to the value of property to a *prospective* owner. For example, a person who is contemplating the purchase of a tract of land must estimate what the ownership of this property would be worth to him, before he can make an intelligent bid. Such an estimate would be an estimate of value to a prospective owner. Again, in a damage case, the plaintiff may be seeking recovery for defendant's breach of contract to deliver certain goods on a specific date. If we do not accept the current market values of these goods as the basis for an award of damages, we may consider, as an alternative standard, what the goods *would* have been worth to the plaintiff if they had been delivered in strict compliance with the contract. This value that the property would have had to the plaintiff if it had been delivered to him is conveniently called "value to the owner," even though the plaintiff never secured title to the property that was contracted for.

[2] For a comment on this distinction, see *infra* pp. 1195–1198.

Value to the Owner Generally Measured in Terms of a Money Equivalent.

When "value" is used in a subjective sense, as it is when we refer to value to the owner, it can be stated in quantitative terms only by comparing what the thing in question is worth with what some other valuable thing is worth.[3] In nearly all valuations of property, this alternative thing that we use as a unit of measurement is money. But any given amount of money, like any specific commodity, would itself be worth more to some individuals than to others. A poor man typically prizes $100 much more than does a rich man. Because the very unit of measurement, money, varies in value as between different persons, value to the owner can be expressed only by balancing what the property in question is worth to some specific owner with what a given amount of money is worth *to this same owner.* If I say that my house is worth $10,000 to me, I mean that to me it is a matter of indifference whether I have the house and not the money, or the money and not the house. But to a richer man this same property might be worth $20,000, not necessarily because he appreciates the house any more than I do, but because he appreciates the dollars less than I do.

Not only, however, does money vary in value as between different persons at the same time; it also varies notoriously in its value to any given individual at different times. Even if the individual himself has not become materially richer or poorer with the lapse of time, changes in the level of prices will be sure to have taken place. My residence, which was worth $20,000 to me in 1929, may now, in 1936, be worth to me only $15,000, because $15,000 will buy all the good things for which I would have been compelled to pay $20,000 before the fall in retail prices.

In order, therefore, to secure a monetary appraisal of property, it is necessary to fix some date of valuation on which to strike a balance between what the property was then worth to its owner and what the money was then worth to him. Some specific valuation date is in fact set by the courts in most judicial valuations. In eminent domain, for example, a particular day of a given year is usually fixed as "the

[3] Economists of the "hedonistic school" have sought for an "ultimate" measure of subjective value in units of pleasure and pain. By this test, property *A* would have twice as much value as property *B* if it were capable of conferring upon its owner twice as many pleasure units. For many years, the hedonistic school has been in discredit with economists and psychologists. More recently it has been revived by some students, in modified form, and its future may possibly be a brilliant one. In any event, the practical appraiser or judge is compelled to measure value in terms of money or other property.

time of the taking," and the amount of compensation is purported, at least, to depend on what the property was worth on this very date. Similarly, in the law of damages, value as of the date of the breach of contract or of the commission of the tort is generally held to constitute the measure of indemnity.

But these valuation dates are necessarily fixed by some arbitrary rule of law, and the valuations which they would seem to require must often do grave injustice to one of the parties to the litigation. One source of injustice is that they take no account of changing price levels. Let us assume, for example, the condemnation in 1929 of a residence property which at that time had, not only a market value but a value to the owner of $20,000. The trial of the case extends to 1934, and the award will actually be received by the owner at the end of this year. If the owner is awarded $20,000, as measured by value at the time of the taking, he will receive money which is now worth to him more than the residence would now be worth to him, had he been permitted to retain it. He may, therefore, be overindemnified for his loss. A contrary situation would present itself were the residence to be condemned during the business depression, when the money values of real estate and of other commodities are low, and were the payment of the award delayed until prices have again advanced materially. Here the owner might be underindemnified were he to receive at the later date what the residence was worth to him on the earlier date.

In several of the chapters on valuation for specific legal purposes, we discuss these problems that arise because of changes in price levels between the official date of valuation and the date of the trial or of the payment of damages. In some cases, the courts have attempted directly or indirectly to make adjustments for the changes. In the main, however, they have held, quite properly, that administrative convenience requires the law to ignore the intervening price changes. Striking injustices result, of course; but only to a limited extent is it practicable to cure them by revising the principles of valuation. They must be attacked from another direction, through efforts to reduce the wilder fluctuations of price levels.

The Value of a Property to Its Owner Is Identical in Amount with the Adverse Value of the Entire Loss, Direct and Indirect, That the Owner Might Expect to Suffer If He Were to Be Deprived of the Property.

The above section heading states one of the most important propositions in the entire theory of valuation. Yet the professional economists, so far as we are aware, have not even mentioned it, per-

haps because they have taken it for granted; while the practical appraisers, the accountants, and the courts, so far from accepting it, have almost uniformly acted on a contrary assumption.

When I say, "My house is worth $10,000 to me," I mean (if I am precise in my use of language) that the retention of the house is worth to me as much as the acquisition of $10,000 in cash would be worth to me. But this is the same thing as saying that the anticipated loss of my ownership interest in the house has an adverse value to me of $10,000. Such negative terms as "anticipated loss," "damage," and "injury," when used as quantitative terms to which dollar signs may be attached, are simply the converse of such positive words as "value," "worth," and "importance." It would be inconsistent to say, "This house is worth only $10,000 to me, although I would not sell it for less than $15,000 because I would suffer so much damage, in the form of inconvenience and expense, if I had to move out of it and take up another abode." The very value that I place upon my present dwelling is influenced by the fact that my ownership of it saves me from incurring these so-called "incidental losses."

This quantitative identity between the value of property to a specific owner, and the negative valuation of the injury that the owner may anticipate from the loss of the property, is frequently recognized so far as concerns the so-called "direct" outlays or disadvantages resulting from the loss. If an owner of a house, for example, would be put to the necessity of buying a substantially similar house for $10,000, in case he were to lose possession of the one in which he now lives, most persons would concede that the amount of this necessary outlay, or "damage," should be taken into account in determining the value of the property to its owner. What they are not so likely to concede is the equally sound proposition that the valuation, if it is to be accurate, must take cognizance of all "incidental" expenses and inconveniences (such as cost and trouble of moving, losses resulting from the necessity of living temporarily in a hotel, and loss of neighborly good will and companionship), which are the necessary result of the transfer of ownership and possession. Aside from practical considerations based either on the doctrine of *de minimis* or else on the ground that incidental expenses and disadvantages cannot readily be estimated, there is no reason why the cost of buying another house should be singled out, to the exclusion of the "indirect" damages, in an estimate of the value of the present house to its owner.

The same situation prevails with respect to the valuation of business property. The value of a particular factory to a business enterprise is not necessarily limited by the cost of building or buying another

factory. If the sale or destruction of the factory would impose other outlays or other losses on the enterprise than mere cost of securing a new building—such as temporary interruption of business, or loss of "locational" good will—then the liability of the enterprise to suffer these "consequential" losses must be taken into account as affecting the value of the existing factory.

In legal valuations the courts recognize a close relationship between what property is worth and what the owner of the property would suffer if he were deprived of the property. They have been most concerned with this relationship in the laws of damages and of eminent domain, where the declared object of the money compensation is to indemnify the owner for his loss, "to make the owner whole."[4] But seldom have the courts gone so far as to attribute to the property a value measured by reference to *all* the injuries; those that are thought of as incidental or "consequential" have been held either not to constitute recoverable damages, or else to be recoverable only under the heading of "severance damages," "special damages," etc.[5] They are not regarded as being embodied in the *value* of the very property that has been taken from the owner. Similarly in the field of fire insurance, the "value" of a building which sets the upper limit of insurable loss under a standard fire-insurance policy is limited, by statute or by common law, to the replacement cost of the structure.[6] Whatever other losses the occupant of the building may suffer because of its destruction by fire must be covered by other policies, such as those insuring against loss of use and occupancy—policies which are not treated as having to do with the *value* of the building itself.

From a practical standpoint, this legal notion of a value that is measured merely by the more direct and standardized losses which an owner would suffer if he were deprived of the property, may be quite justified. There are strong reasons, for example, for the rule of law in eminent domain that an owner of condemned real property should not be permitted to recover for the loss of his business good will, and for the rule in fire-insurance cases that the value of an insured building should not be taken at more than replacement cost. But these practical considerations, persuasive as they may be, in no way impair the force of the statement that the true value of any property to its owner necessarily takes account of all the direct and indirect advantages that the property affords its owner, in the way of saving him from all forms of loss, direct and indirect, "proximate" and "remote." When any of

[4] See Chaps. XIII, XIV, XVI.

[5] See Introduction to Chap. XIII and pp. 410–411.

[6] See *infra* pp. 367–368.

these losses are ignored, "value" becomes a term of art, not of science, and its precise meaning cannot be determined by reference to any deductions from a general definition of the word.

The Value of Property to Its Owner Can Be Stated Only by Reference to the Conditions under Which the Ownership Interest Shall Be Assumed to Cease.

The statement in this heading is a corollary of the previous proposition, that value to the owner is an expression in positive terms of the present adverse value of the loss which the owner would suffer if he were deprived of the property. To illustrate its significance, let us suppose that I own a radio which I could replace in two days with an equally good set at a cost of $100. But suppose that I am planning a party for this very evening and that the whole party would be spoiled if my set should suddenly be stolen or destroyed, there being no time for me to buy or rent another. Under these circumstances, the set may be worth much more than $100 to me. We have here a situation, not unusual in business, where property may be worth, for a time, materially more than its replacement cost.[7] Any later replacement of the property cannot replace *all* the valuable services that the old property was capable of rendering.

In the law of damages, problems suggested by our radio illustration have frequently arisen. The defendant, for example, has defaulted on his prepaid contract to deliver cement to a contractor on a certain date and at a certain place. The current market price of cement may have been $2 per barrel, but the payment of this amount in damages would fail to indemnify the contractor, who not only must buy another shipment of cement, but who also incurs a penalty for delayed completion of the building.[8]

In a litigated case of this kind, the question whether or not the contractor may recover damages over and above the current market price of the cement depends on an application of "the rule in *Hadley v. Baxendale*,"[9] which is discussed at length in our chapters on valuation as a measure of damages. Briefly stated, this rule purports to make the answer depend on the further question whether the defendant was on notice of the contractor's liability to unusual damages in case of nondelivery. If he was on notice, he must pay special damages; otherwise, he is liable only for the market value of the cement, which would here probably be interpreted to mean an imputed value

[7] See *infra* pp. 157–159.

[8] For actual cases illustrating this type of situation, see Chap. XIII.

[9] See Chap. XIII, or any textbook on the law of damages.

based on current prices of similar cement in the market available to the contractor.

But even if the court allows the contractor to recover "special damages," it thinks of these damages as something in *addition* to the value of the cement, rather than as reflecting an unusually high, temporary value of that property. Yet under our interpretation, the cement, if delivered on time, would have had a value to the contractor far in excess of current market price. For the presence of the cement would have saved the contractor from the liability for penalties and from other losses resulting from delayed completion of the building.

Appraisers and accountants, even in so far as they attempt to report the values of assets to a particular individual or to a "going concern," would of course find it impossible to take into account the wild fluctuations in the value of any given asset that take place from month to month, from day to day, and even from moment to moment. In valuing the dynamo of an electric company, for example, they would not base their valuation on the assumption of a sudden, unexpected breakdown of the machine just prior to the peak load of the power plant. Instead, they would assume a contemplated sale or scrapping of the dynamo at some convenient time in the near future, after arrangements had been made to mitigate the expense or loss resulting from the retirement. Of course, they are quite justified in making such an assumption; for seldom does the owner of property confront the problem of choosing between an *immediate* voluntary disposal of his property and its retention. Moreover, if he does confront such an issue, as where an eager buyer suddenly makes a bid for the property "now or never," he has no time to call in an appraiser.

But courts, in damage cases, are often presented with a situation where the property has suddenly been taken away from its owner. And one might have expected them to have developed a concept of value to the owner similar to that which we have developed here. They have preferred, however, to associate "value of the property" with some more stable attribute, such as current market price, or value to the owner under assumed normal conditions, or replacement cost minus depreciation, and to consider separately any claim that the owner of the property may make for special damages suffered by him in addition to the damage that is thought of as reflected in the "value of the property." If the owner of an automobile should bring an action for the conversion of his car, and should claim that this conversion had caused him a total loss of $1,500 due (*a*) to the necessity of buying another car for $1,000 and (*b*) to missing an important business engagement that would have yielded him a profit of $500, most

courts would distinguish between the loss of a car "worth $1,000" and the incidental loss of an opportunity to make a profit. They would not be likely to think of the car as having been temporarily worth $1,500 to the owner because of its usefulness in preventing the owner from missing his engagement. But unless "value" is defined to mean market value, or else to mean the value that the automobile *would* have to the owner under *hypothetical* conditions, the distinction is invalid.

The Value of the Parts of an Organic Whole.

One of the most important but most frequently disregarded truths about value, is that only by a somewhat rare coincidence does the sum of the values of the different parts of an organic whole equal the value of the whole. If the parts are valued as *separated* from the whole, the sum of their values is likely to be far less than the value of the whole. On the other hand, if the parts are valued as *parts* of the whole, their sum total of values may greatly exceed the value of the whole.

The value of any vital organ of a human body, separated from that body, is negligible save for anatomical studies. But its value to the individual who possesses it is coincident with the value of his body as a whole, and therefore of his very life. Without the heart or the liver, the body is worthless and the life ceases.

The same situation applies, to a greater or less degree, with different types of property. What is the value of the left-hand member of a pair of $4 gloves? Practically nothing if the part is valued separately from the whole; approximately $4 if the part is valued as a part of the larger whole. Obviously, neither of these figures—zero or $4 per glove—can be multiplied by two as an expression of the value of a pair of gloves. On the other hand, if we start with the $4 value of the entire pair and prorate that figure between the two gloves by dividing by two, we get a value per glove that is utterly meaningless.

The example of the gloves presents an almost perfect illustration of a case where each part of an organic whole must be valued either at zero or else at the full value of the whole, depending on whether the part is valued as a separate commodity or as a part of the larger unit. This situation prevails whenever each of three conditions is met: (*a*) when each part is utterly worthless except as a part of the whole, (*b*) when no one part can be replaced except at a cost at least equal to the value of the whole, or except after a fatal delay, (*c*) when each part is indispensable to the functioning of the whole. Seldom, however, are all these conditions met with in the valuation of property. Many of the assets of a business enterprise, for example, can be disposed of,

separately from the business, at a substantial price; most of them can be replaced in time to save the business and at a cost much less than the value of the whole business; many of them are not indispensable to the business—the enterprise could get along without them, though with a loss of earning power. Each asset, therefore, is worth neither zero on the one basis of valuation, nor the full value of the entire enterprise on the other basis.

It is nevertheless true that, with rare exceptions, there is a wide disparity between the value of an entire business enterprise and the sum of the values of its various assets or parts. This truth is well recognized when the comparison is between the value of the whole business and the separate *liquidation* values of the assets.[10] But it has been frequently overlooked, or even expressly denied, when the comparison is between the value of the business and the sum of the values of the assets, *valued as parts of the whole.* Misled by the mathematical postulate, applied to spatial relationships, that "the whole is equal to the sum of its parts," many courts, and even some expert appraisers, have falsely inferred that the *value* of an economic whole is equal to the sum of the *values* of the parts.[11] They have therefore often assumed that the value of the intangible assets of a business is equal to the value of the business itself minus the value of the tangibles; or that the value of the eastern section of a railroad, plus the value of the western section, is equal to the value of the whole railroad; or that the value of an easement in real property is equal to the value of the unencumbered fee minus the value of the fee subject to the easement.[12]

Let it here be noted that, in certain legal cases, an assumed equation between the value of the whole and the values of the parts, while false when judged as an attempt to measure "true value," is nevertheless sound when viewed as a practical standard of legal action. Examples in point will be noted in later chapters.[13] But these examples simply illustrate the force of the remark made in an earlier chapter,[14] that there are situations under which a court is quite justified in valuing property, "for the purposes of the case," at an amount which concededly does not measure "value" in any accurate sense of the term. In taxation, for example, an assessor would be warranted in valuing (that is, in assessing) one-half of a house (the other half being

[10] Hence, in enterprise valuations, the fixed assets are seldom appraised at their liquidation values.

[11] See *infra* pp. 422, 677–682, 736–738.

[12] But the Supreme Court took a different position in a leading condemnation case noted *infra* p. 420, note 29.

[13] See *infra* pp. 492–497, 682–691, 736–738.

[14] *Supra* p. 14. See also *infra* pp. 119–122.

located outside his jurisdiction) at one-half of the value of the whole house, even though he were well aware that this valuation does not even approximately measure the actual value of the portion of the building that is officially subject to the tax. This point, however, would not be conceded by traditional law, which would uphold the suggested assessment on the false theory that it reflects the "actual value" of the property.

The example of a public-utility property will further illustrate the fact that the value of an economic whole is not equal to the sum of the values of its assets, valued as parts of the whole. To make the case simple, let us assume that a utility enterprise possesses just two assets—a physical plant and a franchise. Let us further assume that our problem is to find the value of the plant on the one hand and of the franchise on the other hand. Conventional appraisal procedure would purport to solve this problem, first by a valuation of the plant at its estimated replacement cost minus depreciation, and then by a valuation of the franchise by a capitalization of those net earnings of the business which exceed a "reasonable" return on the value already attributed to the plant.[15] It should be obvious, however, that the resulting figures do not disclose either what the physical plant is worth or what the franchise is worth. Replacement cost does not fix, or even limit, the value of the plant; for the plant, were it to be destroyed, could not be replaced in time to save serious, perhaps fatal, interruptions in business. On the other hand, a mere capitalization of excess earnings does not measure the value of the franchise; for unless the franchise is replaceable (or unless the business is permitted to continue operation merely on sufferance and without any franchise), its loss would reduce the value of the plant to salvage value. This means that the plant alone, and also the franchise alone, is likely to be worth to the company as much as the whole business is worth. The sum of these two values has no significance whatsoever, since the one value is necessarily based on a presupposition inconsistent with that on which the other value is based.

Despite the undeniable fact that the values of the parts of a whole cannot be expected to equal the value of the whole, accountants often *talk* as if they assumed that the trick could be turned. In orthodox accounting theory, a balance sheet purports to state the values of the different assets and to sum them up at a total figure which, if it means anything but a mere bookkeeping check, would seem to indicate the value of the enterprise as a whole. Yet it must be obvious from what has just been said, either that the separate assets are not valued at their

[15] Compare the judicially sanctioned methods of valuation under the New York "special franchise" tax: *infra* pp. 595–613.

real values to the going concern, or else that the sum total of these values does not even roughly approximate the value of the whole.

In fact *both* of these conclusions are justified as applied to the usual balance sheet. In the first place, the different assets are carried at figures that cannot reflect what they are worth to the going concern, even though accounting literature often asserts that "going concern values" are sought for. Fixed assets, for example, are carried at actual cost minus conventional allowances for depreciation, or else at current depreciated replacement cost. But neither the actual nor the replacement cost of any one asset approximately measures the harm that would be done to the enterprise if that particular asset were taken away. It would be nearer the truth to say that the modern balance sheet states the amortized costs of the assets, than to say that it reflects their values; although even the former statement would not be accurate.[16]

In the second place, the sum total of the values placed upon assets by the conventional balance sheet does not ordinarily measure, even roughly, either what the entire enterprise is worth to its security holders, or its sale value. No sensible buyer or seller of the enterprises would base his bid or offer price on the asset values reflected on the balance sheet. He would use the balance sheet largely as a means of analysing the company's statements of its annual earning power. Some balance sheets, to be sure, are drawn up in such a way as to reflect the auditor's or the manager's idea of the value of the entire enterprise. When this is done, however, it is accomplished by means of a good-will account. Orthodox accounting treats the item, good will, as if it were a separate asset. The value placed upon it is, therefore, supposed to represent what this special, intangible asset is worth as distinct from what the other assets are worth.[17] But the more nontraditional of the recent writers on good will have clearly shown the fallacy of this assumption.[18]

[16] The orthodox theory of accounting, that the balance sheet is designed to reflect the "values of the assets to the going concern," is perhaps still the prevailing one. But it is fast being discredited by modern writers, especially by the wholesome influence of George O. May, senior partner in the firm of Price, Waterhouse and Company. See, for example, his article: "The Influence of Accounting on the Development of an Economy," *Jour. Accountancy*, January, 1936. See also a recent "Accountant's Report" by that firm, dated Jan. 9, 1936, relative to the accounts of the West Penn Power Company. The report refers to the *assumption* of the correctness of a reappraisal of certain assets, "*which being a question of valuation we, as accountants, cannot pass upon.*"

[17] Conservative accounting practice, however, favors the valuation of good will at a purely nominal value, unless the good will was *purchased* at a measurable price.

[18] See John B. Canning, *The Economics of Accountancy* (New York, 1929), Index under "Goodwill"; J. M. Yang, *Goodwill and Other Intangibles* (New York,

They have pointed out that the good-will account is really a kind of "valuation account" representing, not the value of a particular intangible asset, but rather the difference between the values that accounting practice arbitrarily assigns to the separately stated assets, and the value that the management desires to assign to the enterprise as a whole. Thus, the value assigned to good will is neither the value of any one asset (or characteristic) of the enterprise, nor even the excess in the value of the whole enterprise over the sum of the values of the other assets. It is simply a differential item designed, by a stroke of the accountant's pen, to make the sum-total value placed upon all the assets of the business correspond to whatever figure the management, under the generally lenient eyes of its accountants and auditors, cares to record on the balance sheet as representing the value of the entire going concern.

Turning, now, from accounting to professional appraisal, we might expect to find here a general recognition of the difference between the value of an organic whole and the sum of the values of the parts of that whole. For while accounting practice can be explained largely on the theory that the balance sheet is not really designed to reflect values, appraisal practice cannot so easily be assumed to have in mind some other objective than that of measuring what the property is worth.

The best appraisal literature and practice does indeed recognize the problem, at least under some situations. For example, the Appraisal Code of the American Association of Real Estate Appraisers[19] warns against the assumption that the value of improved real property can be correctly measured by the addition of the vacant-land value of the land to the value or reproduction cost of the building. The property must be valued as a unit, rather than by a summation, although there are cases where the sum of the vacant-land value and of the depreciated reproduction cost of the building may guide the appraiser in reaching the value of the whole. Similarly, an intelligent appraiser, in valuing a large tract of land subdivided into smaller lots, would recognize the likelihood that the separate sale values of the various lots cannot be summed up to give the sale value of the larger whole.

How do the courts meet the issue that has been presented here? Do they make the fictitious assumption that the values of the parts of a larger property can be determined by dividing up the value of the

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1917). Canning, however, apparently takes the position that the *ideal* of a balance sheet is to report true values, whereas our position, like that of May, is that the disclosure of present values is not even an ideal of the standard balance sheet.

[19] See *infra* pp. 1182–1183.

whole? And do they assume that the value of the whole can be found by summing up the values of the parts? The answer is that at times they have made these assumptions, while at other times they have recognized their invalidity. In the valuation of improved land, for example, many courts have held, in accordance with the best appraisal opinion, that the value of the whole property cannot be determined by a summation of the value of the vacant land plus the value of the building and fixtures. And in valuing a large tract of land that is or may be subdivided into separate lots, courts have denied the propriety of assuming that the value of the larger tract is equal to the sum of the values that might properly be attached to each subdivision if valued separately.[20]

On the other hand, in the taxation of railroads under the unit rule, the United States Supreme Court has held that the value of the entire railroad property can be allocated to those portions of the railroad lying within each different state; and it *seems* to have assumed that these allocated values may be expected to approximate what the property in any one state is "really worth."[21] Similarly, in the condemnation cases, where only a part of an integral tract of land has been taken, *most* courts have ascertained the value of the part taken, neither by estimating the price at which it could have been sold separately, nor by estimating the fall in the value of the larger tract consequent upon the taking of the condemned portion, but rather by prorating the value of the whole to its parts as butter is spread over bread.[22] And in tax cases, some courts have assumed that the tangible or real property of a public-utility company can be valued devoid of its franchise, or that the franchise can be valued devoid of its tangible property, by some method which allocates the value of the entire enterprise to the two different parts.

We discuss actual legal cases on these points in our chapters in Part III. Here it should be noted that the courts have been quite justified, sometimes in valuing each part of the property at a "fair share" of the value of the whole, sometimes in ascertaining more directly the separate values. Of course, the first procedure, as exemplified by the unit-rule method of valuing railroad property for tax purposes, does not often result in stating even approximately what each part of the larger property is really worth. But it may, nevertheless, result in a fairer "value for the purposes of the case"—for example, in a fairer basis of taxation—than would the true value of the

[20] See *infra* pp. 541, 703, 716; Lewis Orgel, *Valuation under the Law of Eminent Domain*, Chap. 2, §34.

[21] See *infra* pp. 679–682.

[22] *See infra* p. 422.

property that is being appraised. Throughout the field of legal valuation, one finds the law first starting out with a false doctrinal premise that the objective of a valuation is to ascertain "true value," and then correcting this premise by adopting methods of valuation that necessarily reach some other objective.

Possible Distinctions between What a Thing Is Worth, and What People Think It Is Worth.

In speaking of the value or importance of a thing to an individual, we sometimes mean the importance that the individual himself attaches to it—its *esteemed* importance. But we also sometimes mean the *real* importance of the thing to the individual, thereby implying that property may be worth more or less to its owner than he thinks it is worth to him. What is a gold mine worth to a man who is still unaware of the existence of the gold, but who will discover and benefit by that existence day after tomorrow? And what is a highly marketable stock-option warrant worth to the ignorant investor who receives it in the mail, thinking that it is a useless proxy?

In the latter case, our answer might depend on the question whether the investor will discover his mistake before it is too late. For if he throws the warrant away, his ignorance of its potential value may prevent the instrument from being of any benefit to him. But there are some things, like the human heart, which would serve people even though they were unaware of their very existence. And the same thing is true of some types of property.

Questions like this might lead us into a discussion as to whether there is any such thing as the "real importance" of a thing aside from its esteemed importance. But we may dodge this philosophical debate for our purposes. For it is quite possible to construe value always in the sense of *esteemed* importance and yet to make useful distinctions between what an owner thinks that a thing is worth to him, and what he *would* think if he were a more informed or more intelligent or more sober man. We can appeal from Peter drunk to Peter sober, or from Peter before he makes the discovery of gold to Peter afterward. If each of these various appraisals may be useful, on occasion, in judicial valuation, we need not concern ourselves too seriously with a dispute as to which one of them should be said to represent value in the "correct" sense of the word.

In those court appraisals where value to the owner rather than market value is the desideratum, the possible distinction between the importance that the owner attaches to the property and its "real value" may take either of two forms. The first form concerns the distinction

between a prospective and a retrospective valuation—between the value that would have been assigned to the property in the light of facts and opinions prevailing on valuation date, and the value that would now be assigned in view of subsequent history. The second form concerns the distinction between the importance which the owner attaches to his property on valuation date, and the importance that the court or jury may attach to it on that same date. These situations will now be discussed in turn.

Hindsight Valuations.

Smith is the owner of a farm tract that was condemned by the state on June 1, 1920. Under the law, he is entitled to recover the "value" of the tract on that date. He, himself, would have felt adequately compensated by a payment of $10,000 in cash, and this is also the price at which the land could have been sold under market conditions prevailing at the time. But during the course of the proceedings to assess the damages, the land is found to contain rich oil resources that were not even suspected on valuation date and that would not have been revealed by any appraisal of the land that an owner or buyer might reasonably have made if a voluntary sale had been contemplated. Had the presence of these resources been known on valuation date, the owner would have valued the land at $100,000 for future sale or exploitation; and this is also the price at which the property could then have been sold. Under these conditions, what was the value of the land on June 1, 1920?

If by "value" we here mean market value, which is the usual asserted measure of damages in eminent domain, and if market value is strictly interpreted in accordance with the economists' definitions, the question answers itself. For since the presence of oil was not suspected at this time, the property could have been sold only at its $10,000 farm-land value.[23]

But if "value to the owner" is the desired figure, the question is not so easily answered. By very hypothesis, the owner himself valued the property, at the time, at $10,000. And also by hypothesis, he would not have valued it at a higher sum even if he had taken the advice of competent real-estate appraisers. But the condemnation of the land deprived the owner of an opportunity, not then recognized,

[23] But in actual cases with a state of facts similar to those assumed above, courts have sometimes held that, even though the property is to be valued as of some prior date, account must be taken of natural resources contained in the land on this date but discovered subsequently thereto. See Lewis Orgel, *Valuation under the Law of Eminent Domain*, Chap. 2, §26.

to sell or exploit the land for oil when the oil might have been discovered. And there is some force in the argument that the value of this opportunity, as viewed by hindsight, should be paid for by the condemner. If this argument be accepted and if "value to the owner on June 1, 1920," be taken as the verbal measure of damages, we might construe this "value" to mean the value that the owner would have placed upon the property on the valuation date, had he then possessed the information that has later come to the attention of the appraisers and the court. We have assumed that a value of $100,000 would then be justified for the land in question.

If we accept the general legal doctrine that the object of an award of damages is to indemnify the claimant, the $100,000 value might seem to come closer to the goal than would the award of $10,000. And so it would, if we may assume that, had the land not been condemned, its owner would have become aware of the oil before he sold the property. But we are concerned in this chapter with the concept of "value to the owner," rather than directly with the uses to which this concept may be put as a legal standard. Are we speaking accurately, then, when we say that the land proves now to have been worth $100,000 to the owner on valuation date? Or should we not say rather that the land was worth only $10,000 to him, even though we may also believe that justice requires the payment of the $100,000 which it *would* have been worth to him, had he been gifted with foresight equal to our hindsight?

As a matter of convenience, we prefer to accept the latter mode of thinking. But our preference cannot be based on strictly logical grounds. For if we say that a thing is worth to a man only what he thinks that it is worth, we must then admit that the thing is worth nothing to him except when he is in the very act of thinking about it and valuing it. Indeed, some writers on the philosophy of value have taken precisely this position. But so severe an attempt to be logical would violate too seriously the accepted modes of speech and would require too much circumlocution.

In later chapters, we discuss the actual holdings of the courts as to the use of hindsight in the valuation of property.[24] The general legal doctrine is that hindsight appraisals are unacceptable. But the interpretation of this doctrine has given the courts much trouble and has resulted in many inconsistencies, some of which are quite justifiable.[25]

[24] See index under "Hindsight."

[25] Compare, for example, Ithaca Trust Co. v. U.S., 279 U.S. 151 (1929), with Sinclair Refining Co. v. Jenkins Petroleum Process Co., 289 U.S. 689 (1933),

Does "Value to Owner" Accept Owner's Judgment and Taste in Estimating the Merits of the Property?

We have so far considered the situation where the meaning to be given to "value to the owner" turns on the choice between foresight and hindsight. That is, we have distinguished simply between the importance that the owner actually attached to the property in the light of conditions prevailing on valuation date, and the importance that he would have attached to it *if* he had been gifted with foresight equal to the court's hindsight.

But time need not elapse in order to reveal a difference in opinion as to what a given property is "worth to its owner." The owner himself may value the property at $100,000. I, as a judge or an appraiser, may think that his valuation is absurd and that the property is "really worth" only $50,000 to him. In this latter case, I am doing the valuing, but with the owner's needs or interests in mind.

If the owner of the property himself hires an appraiser to determine its value, he is certainly not paying the appraiser to guess his own mind. Rather, he is hiring him to *guide* his mind. Value to the owner in the sense of owner's valuation is, therefore, never the kind of value that an appraiser tries to report. What the appraiser wants is "reasonable" or "justified" or "warranted" value—the amount at which the owner *should* value the property as a wise businessman.

Similarly in law, "value to the owner" is rarely if ever identified with the owner's valuation. One reason why this valuation is not sought for is that it can seldom be found; for the owner's testimony is almost sure to be biased by his desire for a high or a low figure. But even if the owner, by adducing some overt act such as a recent refusal to make a voluntary sale at a stated amount, could prove beyond reasonable doubt that he himself valued the property at a given sum, a court would not accept this as, in itself, the value for the purposes of the case. In legal phraseology, it is the "reasonable" or "actual" value of the property that is wanted—the value that the property would have in the eyes of a reasonable owner, after he had taken such expert advice as a prudent businessman might be expected to take.

Even aside from the difficulties of proving what importance the owner himself attaches to the property, it is easy to see why a court would properly reject such a valuation in favor of a "reasonable value." An owner may greatly overrate or underrate the benefits that may be expected from his continued ownership of the property. If the prop-

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taking apparently divergent positions on the "hindsight" question. Discussed *infra*, pp. 743–744.

erty is being valued as a measure of indemnity in a damage suit or a condemnation case, his optimism or pessimism should be corrected as far as possible by the tribunal, under the guidance of expert appraisers. Otherwise, the money award that he receives is likely to diverge seriously from the amount that will compensate him for the loss of future benefits of his property.

"Reasonable value," or "value to a reasonable owner," is, of course, an indefinite concept. In the valuation of income-yielding property, not only reasonable laymen but expert appraisers will differ in estimating at what amount the property should be valued by any given owner. A valuation involves forecasts of future events, and it also requires that expected events be discounted by reference to risk of nonoccurrence and to the interest factor. The risk and interest difficulties are especially serious in a determination of value to a specific owner, as distinct from market value; for different owners properly attach different degrees of importance to risk and to time discount. The practical impossibility of taking into account individual differences in the assessment of the risk and the interest factors causes appraisers and courts largely to ignore these differences and to accept such discounts for risk and time as have become standardized on the market place, or by convention.

In the valuation of property that yields direct services rather than money income, such as a residence occupied by the owner or a work of art held by a collector, the difficulties of applying the concept of "value to the owner," even when "owner" is defined as "reasonable owner," are increased. Here we have a situation where reasonable men may differ, not only in their forecast of future events, but also in their tastes. Suppose a case, for example, where a value for tax purposes or for condemnation must be placed on an extravagant and crazily designed residence that has recently been built by an eccentric millionaire at a cost of $500,000. Very possibly the property is almost literally unsalable—that is, its market value is almost zero. Yet the fact that the owner willingly spent half a million dollars to build the edifice strongly suggests, although it does not positively prove, that he still values it at that amount for his own use. How, then, should the property be valued, on the assumption that its mere market value is not to be taken? Should the court or the jury allow its own, presumably more normal, standards of aesthetics to color its valuation, with the result that the residence would be valued perhaps at a paltry few thousand dollars? Or should the owner's tastes be allowed to stand, with the result that the property would be valued at the half million dollars that it has recently cost to erect?

The paucity of "eccentric-property" cases makes it impossible to state the law on this point.[26] And this is unfortunate, since the same problem not infrequently arises in a more disguised form in the valuation of more normal properties, especially designed for their owners' use. We surmise that, in the hypothetical case that has just been posited, the property would be valued either at $500,000 or at this amount minus some arbitrary discount based on the tribunal's feeling that the "property cost more than it is worth." And we also surmise that, if the residence had not been constructed recently, the figure would be based on estimated replacement cost minus a conventional allowance for physical depreciation and minus also an arbitrary write-down for abnormality. A professional appraiser, if asked to value the property, would be likely to say that value is here incommensurable but would offer to submit a report on reproduction cost minus depreciation.

The question whether "irrational" attitudes based on "prejudice" should be allowed to color the valuation of property has been raised in several cases dealing with the measure of damages sustained by landowners because of the erection of high-tension electric wires over their property.[27] The prevailing legal doctrine in these cases is that the electric company is liable for damages based on the resulting decrease in the value of the land. Against the contention of the owners that the presence of the wires constitutes a menace to life and property because of the danger of fire and electrocution, and hence causes an impairment in the value of the land, the companies have presented expert witnesses to testify that the danger is greatly exaggerated in the popular mind, and hence constitutes a largely "imaginary" damage. On this issue some courts have held that the mere generally held belief of the existence of the danger results in an impairment of the value of the land, whereas other courts have held that the belief itself, even though widely held, is insufficient to justify an award of damages over and against the uncontroverted testimony of experts that it is unwarranted. We have here one of those borderline situations where the courts are not uniform in the extent to which they will distinguish between what a thing is worth, and what people think that it is worth.

"Pecuniary" or "Economic" Value.

In defining the value of a thing to its owner as the importance that the owner does or might attach to it, we have said nothing as to the nature of the desires or motives that give rise to the feeling of impor-

[26] But see *infra* p. 746.

[27] See Orgel, *Valuation under the Law of Eminent Domain*, Chap. 4, §60.

tance. To be sure, we have noted that appraisers and courts may invoke the concept of "reasonable" or "warranted" value in order to discount the errors in forecast and the idiosyncrasies of taste of any particular property owner. But "reasonable value" would still seem to include values based on all human motives, whether economic, aesthetic, religious, sentimental, or ethical, that are deemed by the appraiser or the court to be normal.

Here and there, however, in the valuation of property, one finds the statement or implication that there are certain types of values which should not be taken into account by the appraiser, the accountant, or the court, even when value to the owner rather than market value is the desideratum. In valuing the assets of a single proprietorship, for example, the accountant will ignore any value that the property may have to the owner in the role of a consumer rather than a proprietor. In valuing a homestead or a private cemetery, an appraiser would hardly attempt to estimate its peculiar sentimental value to the owner. And in judicial valuation, a court may rule against any allowance for "sentimental value," or for "speculative value,"[28] or for value based on illegal or highly antisocial uses of the property.

One can readily understand why the courts may decline to recognize certain attributes of property that are often highly valued, and reasonably valued, by owners. Difficulties of proof may require them to be ignored, and these difficulties are given as at least one reason for the rule of law excluding an allowance for sentimental value. Public policy may dictate a refusal by a court to recognize the value of property for antisocial purposes—a consideration that may have influenced the Supreme Court in its harsh rulings on the obsolescence of distillery properties for income-tax purposes.[29] But the law has not been very happy in the formulation of its verbal rules whereby the value of property in legal appraisals is held to exclude some attributes of value to the owner. One of these indefinite rules or doctrines is that which restricts the valuation to the "*pecuniary*" or "*economic*" value of the property and which seems to imply that certain values, even though they might perhaps be expressed in terms of a money *quid pro quo*, must nevertheless be disregarded because of their nonpecuniary nature. Thus Justice Butler, speaking for the Supreme Court in a condemnation case, remarked that the owner was entitled "to be put in as good position *pecuniarily* as it would have occupied, if its property had not been taken."[30]

[28] For the legal use of these two terms, see index.
[29] See cases cited *infra* p. 1000, note 43.
[30] U.S. v. New River Collieries Co., 262 U.S. 341, 343 (1923).

In the earlier literature of economic theory, economic motives were often associated with the supposedly more primitive desires of getting a living—of securing food, clothing, shelter, etc. But this distinction is no longer drawn by economists, since it is now recognized that so many other motives actually influence people in their business life. Indeed, few modern economists attempt to draw *any* distinction between economic and noneconomic motives.[31] To be sure, they sometimes refer to "economic value" as something different from "ethical value." But here they are simply distinguishing between the values that people do in fact attach to things, for any reason, and such values as they *should* attach to them in accordance with whatever standard of conduct is accepted by the person who expresses an opinion on ethical value. Even market prices are influenced by *accepted* standards of ethical conduct.

In the author's opinion the most appropriate use of "economic value" lies in the extreme breadth of the term rather than in its restriction to values based on limited desires or motives. The essence of economics, as he sees it, lies in the fact that it studies individuals in society, making the amazing effort, partly successful, to get the most out of life for themselves and others by weighing in the balance values of the utmost qualitative differences—by choosing between eating the cake now and eating it tomorrow; between eating the cake plus being sick tomorrow, and not eating it plus feeling well tomorrow; between eating the cake and letting your sister eat it; between buying the cake and contributing to a hospital or to the church; between making the cake and reading Edgar Wallace; between reading Edgar Wallace and reading Plato; between living in an inconvenient but artistic house and living in a convenient but ugly one; between going onto the stage or going into the pulpit.

Correspondingly, the *economic* value of an object of wealth—or of the institution of football or the law of gravity, for that matter—refers to the value of the object in view of *all* of its expected uses, as distinct

[31] Perhaps this remark should be qualified by the statement that most economists think of the economic value of any object as an *instrumental* value—as reflecting the importance of the object as a means to an end rather than as an end in itself. If a man values his wife for money-making purposes, his valuation reflects economic value. Even if he values her for her pleasant companionship, he is still placing an economic value on her. But if he values her because of his interest in *her own* happiness or well-being, he is placing a noneconomic value upon her. On the other hand, if he values a house because of the contribution that it will make to his wife's well-being, he is placing an economic value on the object. Here the house is valued as a means to an end, even though the end is someone lse's happiness, not that of the valuer.

from its value in view of any particular use or group of uses that we may single out. A house may have great aesthetic value in the eyes of an artist. But if its location is so inconvenient or its plumbing is so poor that the artist himself would prefer to live in some other, less beautiful house, then the first house has less economic value to this particular artist than does the second, despite its greater aesthetic value. Even here, the aesthetic values of the two houses are factors in their economic value, although they are not the only factors.

Sentimental Value.

Further comment is required on sentimental value. It is frequently asserted to be a general rule of law that the valuation of property must disregard sentimental value.[32] But even when the courts announce this doctrine, they do not mean that the property should be valued only at what it would be worth if it were devoid of all sentimental associations.

With some types of property, not only the value to some specific owner but also the market value is affected by attitudes that are generally thought of as sentimental. If the sentiment attached to wedding rings should suddenly disappear, their market value would drop to little or nothing above their gold-content value. Yet, in a legal valuation, their full market value in view of the prevalence of existing customs and feelings would be allowed. The same rule would be applied to a homestead occupied by George Washington, provided that the historical association would permit the owner of the property to command a higher price in the market than he could otherwise secure. It is at most only the peculiar sentimental attachment of the *specific* owner to his property, rather than the price dictated by a widely prevailing sentiment, that a court wishes to exclude.

But even where the property has a sentimental value only to its present owner, the traditional doctrine against allowance of sentimental value does not mean literally what it seems to mean. The owner of a family portrait which has been destroyed by a tort-feasor might not have been able to sell the picture for a single penny. Moreover, the property may have been worth nothing to the owner himself except for its sentimental associations. Yet in such a case, the owner may not be limited to a recovery of nominal damages. He may recover damages based on what the court is likely to call the "intrinsic value" of the portrait. Just what a judge thinks that "intrinsic value" means, when he interprets it to mean neither sale price nor sentimental value, remains a mystery to us after reading the reported cases. But

[32] See Chap. XIII.

the types of evidence that are admitted in cases of this sort suggest that the tribunal will award some figure not far different from the estimated cost of having a portrait painted by a current artist of similar reputation and skill. The award is, therefore, an arbitrary award, and only by accident can it approximate the *value* of the portrait in any accurate sense of the word.

Relation between Value to the Owner and Market Value.

Although certain properties are worth to their owners far more than their market values, there is, nevertheless, a sufficiently close quantitative relationship between the two so that the one value may sometimes be used as an index of the other value. Indeed, the most plausible defense of market value as the usual measure of compensation under the laws of damages and of eminent domain is that it is often the best available measure of value to the owner.

When market value is interpreted to mean the net price at which the owner could presently sell the property, it may often be assumed to measure the *lower limit* of value to the owner. Even if the property is otherwise utterly useless to the owner himself, it has a value to him for the purpose of exchanging it for money. To him, therefore, it is worth at least its gross market value less allowances for selling expenses and other losses incidental to the negotiation of the sale. Even this generalization, however, is not *invariably* valid. An automobile dealer may own 100 automobiles, any one of which he might presently sell for $1,000. The market value of each car in the dealer's hands is, therefore, $1,000. Yet no one car is necessarily worth this price to the dealer; for his market is limited, and the sale of any car may reduce his chances of selling the remaining cars. Under such circumstances, if the dealer were entitled to damages for the loss of one of his cars, an award of retail market price, even after the deduction of selling expenses, might overindemnify him. Recognition of this likelihood is one of the expressed reasons why courts in damage cases do not usually allow dealers to recover the retail prices of their stock in trade.[33]

Net market value not only often sets the lower limit of value to the owner. It may also set an upper limit if it represents the price at which the owner could replace his property with an equally desirable substitute. To the owner of ten shares of United States Steel stock, these shares can hardly be worth more than their current market price, not even if an investment analyst correctly concludes that the "intrinsic value" of the stock is in excess of this price. Were the owner to lose the stock, an immediate payment to him of its market value would

[33] See Chap. XIII.

"make him whole" by giving him the funds with which he could secure ten other shares of the same stock. Of course, if a precise determination of the value of the stock to the owner were desired, an appraiser would have to consider the possibility that this value exceeds market value to the extent of brokerage commissions plus an allowance for the trouble imposed upon the owner in replacing the lost security. But such items are trival in the example that we have chosen.

Where property has a market price which represents both the price at which the owner could sell and the price at which he could buy, as is approximately true with active stock and bond issues, it is ordinarily fair to assume that this market price is the actual measure of the value of the property to the owner. Here the two limiting factors coincide, so as to form a single index of value to the owner. With most types of property, however, there is a material spread between buying price and selling price, as in the case of a grocer who buys at wholesale and sells at retail. Here the property may be worth to its owner its replacement cost, or its net selling price, or some amount between these two figures. We discuss problems of this nature in the chapters on value as a measure of damages. Usually it is impossible here to determine with confidence the value of the property to the owner; and the courts quite properly resort to somewhat arbitrary rules, such as the rule in most damage cases that recovery is limited to replacement cost.

While market value is frequently accepted as a legal standard of value because of its supposed correspondence to value to the owner, the latter is far less frequently taken as a measure of the former. This is true because, as a rule, the market value of property is easier to ascertain than the worth of that property to a specific individual. Moreover, market value is generally of far greater influence in determining value to an owner, than the latter is in determining the former. To most individuals the market is an impersonal thing which they cannot materially influence by their bids and offers and which they must accept as the basis for their own, subjective valuations. But the value that an individual places on his property has little bearing on the price at which he can sell it, since a buyer is not concerned with the worth of the property to the seller.

Summary.

The major points developed in this chapter on value to the owner may now briefly be summarized.

Whenever "value" is not identified with market value (or with some hypothetical market value, like "justified selling price") it prop-

erly refers to the value of the property to some specific person or group of persons. The same property would have very different values to different individuals, and the worth of the property is not ascertainable without reference to the question, Worth to whom?

Value to the owner is generally measured in terms of money, and is then set by the amount of money that would just compensate the owner for the loss of the property. "Value" is here simply a positive expression of the negative value of those injuries that the owner might anticipate if his property were taken from him.

In legal valuation, as in accounting and professional appraisal, the "value" of property is sometimes associated only with those more direct and more usual losses that an owner would incur were he to lose the property. Replaceable property is therefore frequently assumed to be worth its replacement cost, because the owner might be impelled to replace it, were he deprived of its use. But the fact that the owner may also suffer important incidental losses, which he cannot avoid by replacing the property, is not always taken into account in an appraisal. It *should*, however, be taken into account if the objective is to find the full value of the property to its owner.

In the valuation of a part of a larger system of properties, say in the valuation of that portion of the New York Central railroad track which lies in New York State, the sum of the values of the parts is typically either much less or much greater than the value of the whole. If the parts are valued at their separate liquidation values, the sum of their values will probably be much less; but if they are valued at what each is worth to the owner who possesses the remainder, the sum of their values will probably be much more. The value of either member of a pair of gloves is alternatively practically zero or practically equal to the value of the entire pair.

"Value to the owner" may be used in any of three different senses, each of which may justify a different valuation. It may mean (*a*) how the owner actually values his property, or (*b*) how he *would* value his property if he made an intelligent valuation in the light of data available on valuation date, or (*c*) how he *would have* intelligently valued the property if he had possessed on valuation date, such data about the property as have subsequently been revealed in a hindsight appraisal. When the courts depart from the standard of market value and adopt value to the owner or some apparent synonym like "real value," they *generally* have the second of these three meanings in mind. But the cases show no perfect consistency on this point.

Many of the legal cases state or imply that some attributes of property that give it a value to its owner should be disregarded by

the tribunal. "Sentimental value" is often said to be excluded, and some courts have indicated that allowance may be made only for the *pecuniary* value of the property. These rules of restriction are not happily phrased by the traditional legal jargon, and they do not always mean what they seem to mean. Property which has no value to anyone, if not a sentimental value, is frequently assigned a material value by a court. The distinction between pecuniary or economic value, and nonpecuniary or noneconomic value is of doubtful validity, unless it is interpreted to mean that no property which does not yield a direct *money* income has a pecuniary value. But, if so interpreted, the courts would be compelled to deny any "value" to valuable commodities that are held "for use" rather than for a money yield; and this they have not done.

The value of property to its owner is greatly influenced by, and is sometimes measured by, its market value. Property is ordinarily worth to its owner at least the net price for which the owner could sell it, although there are exceptions to this rule. Property is also ordinarily worth little more to its owner than the price at which the owner could quickly replace it with an equally desirable substitute, although the exceptions to this rule are numerous. Stocks and other highly marketable properties that can be bought or sold by the same person at substantially the same price are usually worth to their owners no more and no less than their current market prices.

Appendix on Economists' Concepts of Marginal Utility and Subjective Value.

Although the economic theorists have usually identified "value" either with market value or else with a normal price that is supposed to determine market value in the long run and under competitive conditions, certain schools of economics have developed concepts closely related to that of value to the owner. The more important of these concepts are "marginal utility" and "subjective value"; and a brief explanation of each is in order here.

Marginal Utility.

Just as the classical economists associated value with cost, so a later school of economists, coming into prominence in the latter half of the nineteenth century, associated value with utility. Jevons in England, Menger, Boehm-Bawerk, and Wieser in Austria, Walras in Switzerland, and John Bates Clark in this country, attempted to develop a more fundamental theory of the forces determining market values than the classical economists had succeeded in doing with their theory of normal price. They fixed their attention on the demand side of exchange transactions rather than on the supply side and found the price-fixing forces in the varying intensities of individuals' wants rather than in the varying costs of production. The thing that gives value to a commodity they found, not in its costliness, but rather in its capability of satisfying a want—in other words, in its utility.

But to make utility the basis of value, the new school had to give a satisfactory answer to the problem suggested by Adam Smith when he called attention to the high exchange value of the unessential diamond and the low exchange value of the indispensable water. To meet this situation, they developed the concept of *marginal* utility. Human wants for any one kind of commodity, they pointed out, are subject to a law of diminishing importance. Some wants for a particular commodity are urgent, other wants less so, and others still less. Therefore, when our supply of a commodity is limited, we assign the units of the supply to the satisfaction of the more important wants. The utility implied in the least important want, which we are in a position to satisfy with the given supply, is the *marginal* utility for that supply. It measures the importance of *any* one unit, since, if one unit of the supply were destroyed, only the least important want would go unsatisfied. As the units of a supply are (by definition) interchangeable, the marginal want or the marginal utility thus determines the importance of any single unit of the stock. For example, on a hot day we may want one glass of lemonade very keenly, another glass less keenly, a third barely, and a fourth not at all. If, then, we had a supply of three glasses, the marginal utility of lemonade would be low, since our desire for a third glass is low, and *ipso facto*, no specific glass in the supply would be of much consequence. If we had a supply of four glasses, the marginal utility of lemonade would be zero since we care not at all for a fourth glass—one glass out of the supply could be destroyed without injury to us. No individual unit of the supply has any importance to us, though the supply of lemonade taken as a whole may have great importance.

By this concept of marginal utility the new school of economists undertook to explain why Smith's water had little or no value, whereas his diamond had great value. The water exists in such abundance that it has no marginal utility; the diamonds are so scarce that they have a high marginal utility.

Some exponents of the marginal-utility theory, notably John Bates Clark and E. R. A. Seligman, have even argued that the relative market values of various commodities and services correspond directly to their relative marginal utilities. In order to make this point they have adduced the concept of *social* marginal utility, distinguished from the marginal utility of any type of commodity to a particular individual. In our opinion, this concept is abortive for reasons well stated by B. M. Anderson, Jr., in his stimulating book on *Social Value* (New York, 1911). The Europeans of the marginal-utility school, Jevons, Menger, Boehm-Bawerk, and Wieser, found no such simple correlation between marginal utility and market value—between the capacity of a marginal unit of any commodity to satisfy a want and the market price of that commodity. They made use of the concept of marginal utility to explain the creation of a social-demand curve composed of the many demand curves of individual buyers of the commodity. But their explanation of the relationship between marginal utility and market value is too complex to justify its being stated in this treatise.

Subjective Value and Value to the Owner.

Several members of the marginal-utility school, especially the Austrian members, have made use of the term "subjective value." It remains to note whether they so interpreted this term as to make it interchangeable with our "value to the owner."

Boehm-Bawerk, who clearly sets forth the concept employed by the utility school, defines subjective value as follows:

"Value (*Wert*) in the subjective sense is the significance which a good or a complex of goods possesses for the well-being of an individual. . . . "[34]

This seems to suggest essentially the same concept that we have in mind in defining subjective value as "favorable importance," although it identifies value with the well-being which the thing contributes to the individual, whereas we find it convenient to think of value more frequently in terms of the individual's want for the thing, irrespective of the effect of the satisfaction of the want on his well-being. But the distinction is not important for Boehm-Bawerk's purposes.

In considering subjective value, Boehm-Bawerk also uses the terms "subjective use value" and "subjective exchange value."[35] The first term refers to the importance of a commodity to an individual in view of the individual's own uses for it. The second term refers to its importance in view of the importance of anything that the individual can get by selling or exchanging it. Thus, my overcoat may have a considerable subjective use value to me because I can conveniently wear it; but it may also have a considerable subjective exchange value to me because I can sell it for $10 and buy a pair of shoes with the proceeds. This distinction is consistent with our own interpretation of value to the owner, where we point out that, ordinarily, any property is worth at least as much to its owner as the net price at which he can sell it, although it may well be worth *more* to him than that.

In his chapter on Complications[36] Boehm-Bawerk points out that the subjective value of any commodity cannot be greater than the value of those things which the individual would willingly part with in order to make good the loss of the commodity in question. The possession of *some* overcoat may be so important to me that I would give $10,000 rather than to go without. But if I can at once replace my particular overcoat with another, equally good one, by paying $50, then my present overcoat has a subjective value of only $50. This is a fundamental principle in the appraisal of property and in the law of damages, as it constitutes the basis for valuations of property by reference to replacement cost.[37]

On the whole, Boehm-Bawerk's subjective value seems to correspond to our "value to the owner," although he ignored many of the implications of the concept that we have felt it necessary to consider in a treatise on appraisal.

Most American economists have made but little use of the term "subjective value," nor have they often distinguished between it and marginal utility. Ely's *Outlines of Economics*[38] distinguishes between market value (or "objective value") and subjective value, and defines the latter as a "person's estimate of the importance of possessing" a "good as compared with the importance of possessing other

[34] Eugen von Boehm-Bawerk, *Grundzüge der Theorie des Wirtschaftlichen Werts*, p. 4. See also Conrad's *Jahrbücher*, 1886, neue Folge, XIII, pp. 1–32, 477–541. Quoted by H. J. Davenport, *Value and Distribution* (Chicago, 1908), p. 296, whose critique of the traditional theory of economic value is one of the most brilliant discussions of the problem. See also Davenport's *Economics of Enterprise* (New York, 1913).

[35] See his *The Positive Theory of Capital*, Smart's translation (New York, 1923), pp. 166–169.

[36] *Ibid.*, pp. 155–157.

[37] See Chap. IX, *infra.*

[38] Richard T. Ely and others, *Outlines of Economics* (5th rev. ed., New York 1935), p. 165.

goods." This definition apparently corresponds to our own concept of "value to the owner," although for convenience we prefer to assume that the "other goods" take the form of money rather than of other commodities.

The distinction between subjective value and marginal utility is a very important one. To illustrate it, let us take the example, familiar to economists, of the boy with six apples. The marginal utility to this boy of the apples is the importance to the boy of having *a* sixth apple, and can be thought of by supposing that the boy has lost one apple but is unable to replace it with another, sixth apple. On the other hand, the subjective value to the boy of any one of these apples, taken separately, is the importance to the boy, not of having *a* sixth apple, but rather of having this particular apple that is being valued. But if the boy can at once replace the apple merely by climbing a near-by apple-tree, then the importance of this apple is negligible even though it may have a high marginal utility as the latter term is usually construed by economists. In the appraisal of property, the possibility that the owner might be able to limit his loss by replacing the property must always be kept in mind. Hence, subjective value (or its legal equivalent, value to the owner) is a far more important concept in legal and commercial appraisal than is marginal utility.

CHAPTER V

THE CONCEPT OF PROPERTY AS AFFECTING THE CONCEPT OF VALUE

Disputes as to Value Often Dependent on Disputes as to Nature of the Property in Question.[1]

Some of the most puzzling problems raised by the law of valuation are due, not to the difficulty of defining and measuring value, but to the uncertainty as to the precise nature of the thing, the value of which is to be ascertained. In the condemnation of a tract of land, for example, the taking of the land from its owner may cause him to suffer many injuries (such as the expenditure of time and money in moving to another location, or a loss of good will resulting from the enforced relocation of his business) for which he would not be fully compensated if his recovery were based entirely on the value of the condemned land as the word "value" is generally construed by the courts. In these cases, the law has delimited the right of the owner to recovery for his losses by distinctions of a confusing nature and of difficult practical application between property that is "taken" by the condemner (for which the condemner must make payment) and property that is merely destroyed or injured without being "taken" (for which no compensation need be paid in the absence of a special statutory provision to the contrary). The problem of valuing property in condemnation cases therefore raises the prior question, What property is to be included in the valuation?

Other fields of law present this same difficulty in one form or another. A tax statute may provide that the "property," or the "real estate," or the "special franchise" of certain public utilities shall be subject to an annual ad valorem tax. Almost invariably, however, the nature of the property is not precisely defined, and the courts must do their best to interpret the statute by the aid of their common-law traditions as to what is meant by "property," or by common-sense notions as to what thing is fairly to be included in the tax base. In stock-watering cases, where creditors are charging stockholders with a liability on stock issued in excess of the value of corporate property, the court often faces the question whether or not to exclude promoters'

[1] C. Reinold Noyes' important treatise on *The Institution of Property* (New York, 1936) appears too late for use in the preparation of this chapter.

services and other intangibles from the valuation, on the ground that they do not constitute "property" within the meaning of the applicable law.[2] In public-utility valuations for purposes of rate regulation, many disputes have arisen as to whether "the fair value of the property used and useful in the public service" properly includes the value of certain intangibles, such as franchise value or good will. In the valuation of condemned real estate held in divided interests, the question presents itself whether the land should be valued "as land" (that is, as if it were held in fee simple), or whether each distinct interest should be directly valued.

These perplexing questions as to the nature of the thing to be valued might seem to be of no concern to the student of valuation, however important they are for the student of other legal problems. The appraiser, one might suppose, can afford to take for granted the answer to the prior question as to what it is that he is supposed to value, addressing himself merely to the problem of defining and measuring the value of that particular thing which, under the ruling of the court, it is his task to appraise. Unfortunately, however, the two problems are so closely intertwined that they cannot satisfactorily be treated as independent subjects. How one shall define property in a given case is bound up with the question how one shall find value in that same case. The two problems must be treated together by persons who understand their interrelationship.

Often, indeed, a court, in instructing the jury to find the value of a specific property, or in permitting expert witnesses to testify as to its value, will not state its nature with sufficient precision to foreclose the question as to the precise thing to be valued. Sometimes a court will apparently define the property in one way, only to throw doubt on the soundness of its definition by announcing apparently contradictory rulings as to the way in which the *value* of this property must be ascertained. In the stock-watering cases, for example, the New Jersey and Delaware courts have frequently stated that the prophesied earning power of an incorporated business is not "property" and is therefore not a proper basis of valuation by which to ascertain whether or not the par value of the shares exceeds the fair value of the property for which they were issued.[3] Such a statement seems to imply that the one thing which gives to most business assets their value, namely, capitalized prospective earning power, must be left out of account for the purposes of measuring stockholders' liabilities. A closer study of the cases, however, justifies no such amazing interpretation of the dictum deny-

[2] See *infra* pp. 795–797.

[3] See *infra* pp. 807–808.

ing that expected earnings constitute "property." But it leaves one in doubt as to what the courts that utter this dictum really mean by "property," the value of which they declare to be independent of anticipated income.

Ambiguity of the Word "Property."

One of the major sources of confusion as to the precise nature of any given property, as the thing to be valued, lies in the many different senses in which the word "property" has been used by the courts.[4] In earlier law, property was often identified with that congeries of legal rights which is suggested by the popular term "full ownership," or by the legal term "fee simple" as applied to real estate. Because the law of early capitalism concerned itself so largely with rights of full, undivided ownership, and because these rights attached mainly to specific, tangible objects, like land or chattels, the property rights in these objects were closely identified with the objects themselves.[5] The term "property," therefore, came to mean, not merely the bundle of legal rights[6] which people have in things and in other people, but also

[4] Professor R. R. B. Powell of the Columbia University Law School has informed the author that the New York statute law reveals at least fifteen divergent definitions of real property alone.

[5] But what is now thought of as the old-fashioned conception of property, as a tangible object to which property rights attach, was in fact a comparatively modern innovation, an outgrowth of economic individualism. "In time, by dint of repeated use, a 'property in' became simply a property; and with metaphysical significance worn away, it came to denote an objective reality." Walton H. Hamilton and Irene Till, article on "Property," 12 *Ency. Soc. Sciences* 528 at 529. In a sense, then, the "newer view" as to the nature of property is a reversion to an older view, but without the mystical associations between the thing and the person that formerly prevailed.

[6] Throughout this chapter we use the term "legal rights" broadly, to include all those favorable legal interests that Hohfeld has analyzed into rights, powers, privileges, and immunities. W. N. Hohfeld, "Some Fundamental Legal Conceptions as Applied in Judicial Reasoning," 23 *Yale L. J.* 16 (1913), 26 *ibid.* 710 (1917).

In an appraisal of property, account must be taken, not only of all of these favorable interests, but also of the correlative adverse interests that attach to ownership—in Hohfeld's analysis, duties, liabilities, no-rights, and disabilities. But from the standpoint of appraisal, Hohfeld's concepts have only a limited application, since it is seldom that one must value, say, a right devoid of a privilege, or a privilege devoid of an immunity. Even in *legal* appraisals, the more conventional divisions of interests in objects of wealth, such as that between a mortgage and an equity or that between a life tenancy and a remainder, are the most significant divisions.

The person who identifies property with legal rights faces a difficulty in the fact that legal tradition attempts to distinguish between property rights and personal rights, often rephrased as "rights in rem" and "rights in personam." The

the very objects, particularly the tangible objects, to which these rights attach. A court, no less than the layman, will sometimes refer to a tract of land or a shipment of wheat as property, and will sometimes refer to the legal interests of people in this land or in this shipment as property.

In recent times, the law has greatly extended its protection of interests, particularly of business interests, which cannot be identified with any specific tangible objects; with the result that the mental association of the judges between property rights and physical wealth has become much less close. The split has been further widened through the development of newer kinds of divided interests in wealth—particularly by the growth of the corporation, which drives a wedge between the assets of a business on the one hand and the ownership interests of the investors on the other hand. Modern developments in the nature of property have compelled the courts to place values on many things, such as franchises, copyrights, good will, and shareholdings, which cannot be identified with specific physical objects. Even today, however, judges no less than laymen constantly speak of physical commodities as if they, and not merely the rights or interests which people have in them, were proper subjects of valuation. In a condemnation case, for example, it is "the value of the land," or "the value of the land with its improvements," which the courts usually set forth as the thing to be valued. In a damage case, it is "the value of the destroyed automobile," or "the value of the lost ship," and not "the value of the owner's legal interest in" the automobile or the ship which the courts purport to be finding.

Do Appraisers Value Objects of Wealth or Merely the Legal Rights in These Objects?

The question may be raised, however—indeed it has often been raised by legal and economic writers—whether pecuniary valuations of

essence of the former right is supposed to lie in its availability against all the world, whereas the personal right is available only against specific individuals. But this distinction, if rigidly adhered to, requires the legal analyst to speak of "property in one's own person," in order to take account of the fact that such personal attributes as one's reputation are protected by rights available against all the world. Yet the tort lawyers do not regard an action for injury to personal reputation as involving a "tort to property." The truth is that there is no single distinction between property rights and personal rights. But in legal valuation, such distinctions as the courts actually make are important, since the law accords more safeguards to those rights that it brings under the category of property. The force of the popular criticism that the law is more tender of property than of persons is repeatedly illustrated in the realm of appraisal.

the type with which the courts are concerned are not invariably valuations of rights rather than of tangible objects. Those who raise this question generally conclude that all property is incorporeal or intangible, and that all pecuniary valuations are valuations of mere rights rather than of physical things. When we say that this piece of land is worth $10,000, or that this automobile has a market value of $2,000, we are simply using an elliptical expression for the statement that the ownership interests in the land are worth $10,000 and that the ownership interests in the automobile can be exchanged for $2,000.[7]

In so far as the statement that rights rather than physical objects are the things to which we attach pecuniary value implies merely that we value our interests in these objects rather than their mere existence, no exception can be taken to it. When I say that my farm is worth $10,000 to me, I certainly cannot mean that its mere existence as a farm is worth $10,000 to me; otherwise, it would be a matter of indifference to me whether I or someone else were to have the advantage of its ownership. But it may still be doubted whether legal rights (with their correlative duties) are the *only* things that the courts have occasion to value. It may be elliptical to say that we value a piece of land at $10,000; but is it any more accurate to say that what we value at $10,000 is simply our legal ownership rights in the land?

Certainly this statement would not be accurate for all types of valuation *outside* the courtroom. To a bootlegger, a stock of illegally possessed whiskey may have great value, and to a thief a stolen diamond may be worth a material part of its ordinary market value. Yet these values are due only in very small degree to those limited legal rights which the bootlegger and the thief have with respect to their possessions—rights of ownership against persons other than the government or the rightful owners. It is the concealed possession of the whiskey, together with the enjoyment of illegal police "protection," and together with a community feeling which condones the violation of prohibition laws, which accounts for the valuable interest in the illegally held wealth.

It might be said, of course, that the example of illegally held goods is not an apt illustration for the theory of *judicial* valuation, since it presents pecuniary values which the courts refuse to recognize. In these cases the courts might say that the commodities had no "value

[7] John R. Commons, *Legal Foundations of Capitalism* (New York, 1924), p. 158, notes that this point was made by the British economist, H. D. Macleod, in 1881 in his *Elements of Economics*, Vol. I, p. 153. Macleod rejected both commodities and feelings as the subject matter of economics, and held that only rights are bought and sold. Many later economists have expressed the same point of view.

in law," thereby seeming to confirm the assertion that only *legal* rights are the subjects of valuations.[8] But the example of unlawful wealth suggests that in other cases, where there is no positive *antagonism* between legal rights and valued possessions, the full value of these possessions is not exhausted by a valuation of the legal rights designed to protect the interests of the owner. The withdrawal of the legal rights, while it might seriously affect the value of the things in question, would not completely destroy them, because their appropriation and more or less exclusive use are also protected by nonlegal sanctions. An unpatented invention, a secret process of manufacture, a noncontractual agreement or promise, a reasonable expectation of a continued business patronage from satisfied customers ("good will" in one sense of that many-sided term), might well have material values even if the law denied them all those protections which it accords to property rights.

To be sure, a defender of the view that judicial valuations are always valuations of legal rights might reply that the mere recognition of these values by the courts as a basis for determining claims and liabilities, *by that very fact* is a recognition that they represent property rights. If a court protects the good will of a business by imposing penalties on those who injure it in certain ways—for example, on those who ruin it by false rumors about the business, or on those who fail to live up to contractual agreements to refrain from setting up a rival business in the neighborhood—does it not, by that very act, recognize good will as a kind of property right? Indeed, may we not then define good will, for purposes of a legal valuation, as the right of an individual to be undisturbed by certain actions of others that may injure his business?

But any such attempt to identify the subject of all judicial valuations with a specific legal right or bundle of rights must fail. When courts value the good will of a business, they do not value simply that portion of the earning power of a business which would disappear if the legal protection which the law affords against infringers of that good will were to be taken away. They value the entire good will, including that portion of it which would persist even though no legal protection were accorded it. It is impossible to pick out any one right, or any

[8] But if one thief converts a stolen diamond possessed by another thief, he is liable to the former for the "market value" of the diamond. This value certainly does not represent the value of the plaintiff-thief's congeries of rights in the diamonds, and it doubtless ex~~ceeds the lo~~ss which he suffers because of his lost opportunity to sell the diamond. For a thief can rarely get the normal market value for his stolen goods. He must sell in a risky, "fence's" market.

collection of property rights, the value of which represents what the courts call "thevalue of the good will."

At first it may seem difficult to reconcile the fact that the courts value other things than property rights with the fact that they seek these values for the very purpose of settling disputes *relative* to property rights. The answer to this puzzle is that the things which the courts value are not usually identical with the rights, the iufringement of which calls for the valuation. Suppose, for example, that someone impairs the good will of my antique-furniture business by spreading false rumors that my antiques are all "faked." My recovery may be based on the injury to the value of the business caused by these rumors. But the fall in its value for which the defendant is legally responsible is not identical with the value of my legal right to have either this particular defendant, or all the world, refrain from the guilty conduct.[9]

Even in those cases where the thing to be valued may be regarded as a specific legal right or bundle of rights, the rights that are valued are often very different from the rights that are in dispute. For example, in the condemnation of land held in divided interest (as between leaseholder and fee holder), it has been held in most jurisdictions that the condemner's *total* liability is measured by the value of the land "as land"—meaning, presumably, the value of an undivided fee ownership of the land. Yet such an undivided ownership does not exist in fact. It is a *hypothetical* group of rights. Again, in the condemnation of a tract of land which is an integral part of a larger tract, some courts will base recovery on the difference between the value of the owner's whole tract before and after the taking. Yet the ownership interest in the whole tract has not been condemned; it is valued simply as a first step in measuring the damage done by the "partial taking." Having in

[9] Suppose that the plaintiff, just prior to the spreading of the false rumor, had been asked to place a value upon his legal right against X (who subsequently becomes the defendant) with respect to the spreading of false rumors. If he did not anticipate that X had any such malicious intentions, he would probably have valued his legal protection at a small sum. Even if he did anticipate the action, he would probably have valued his legal protection at a lower amount than the amount of the probable award for damages, since he would have been doubtful as to his success in winning the suit, as to his ability to collect a judgment (in case X were not financially solvent), and as to the adequacy of the award to cover all of his direct and indirect losses, including the expenses and trouble of litigation. To put the matter in other words, one cannot say that the adverse value of an injury for which the law allows a recovery represents the positive value of the right which the plaintiff invokes when he seeks a recovery for that injury. In short, when a plaintiff recovers damages measured by the "value of his property," he typically recovers more than his *legal* rights in that property were worth at the time of the injury.

mind this fact that the courts value many things other than actually existing legal rights as a means of settling claims arising from the infringement of these legal rights, we can readily understand why judicial valuation is not necessarily confined to a valuation of property rights. It includes valuations of all sorts of human interests or opportunities—interests, the values of which are not identical with the values of those legal rights that are designed to aid in their protection.

We conclude, therefore, that the sophisticated, modern view of property as consisting of a congeries of property rights, and of property value as consisting of the value of these rights, is not so logically watertight as its pedantry might lead one to assume. Indeed, no general characterization of the sort of thing that we value when we appraise "property" is satisfactory in all cases, although the statement that what we value is "legally recognized interests" perhaps comes as close as any short substitute. Elliptical expressions, such as "the value of the land," or "the value of a suit of clothes," are quite legitimate for many purposes.

Practical Importance to Valuation Law of the Changing Concept of Property.

To the reader who is interested only in the practical aspects of valuation, most of the preceding discussion may seem to be merely academic. For example, in a case involving the condemnation of a piece of land, what difference does it make whether we say that the thing to be valued is (*a*) the land itself, or (*b*) the legal rights in this land enjoyed by the persons who claim compensation, or (*c*) the opportunities of income of which those persons are deprived when the state condemns "the property"? Will not any of these three expressions of the subject of the valuation lead a court and a jury to reach the same results?

Professor John R. Commons gives the correct answer to this question in his book on the *Legal Foundations of Capitalism* (New York, 1924).[10] Tracing the history of American cases in which the courts, particularly the Supreme Court, have passed on the question as to what constitutes "property," Commons notes that they originally tended to identify the concept with tangible objects of wealth, then to think in terms of specific legal rights, and finally to enlarge the concept so as to make it cover many opportunities and expectancies of income,

[10] See, especially, Chap. 2. See also his *Institutional Economics* (New York, 1934).

the source of which cannot be traced either to a particular physical asset or to a particular bundle of rights.

One manifestation of their changing viewpoint is their extension of the protection which they have granted to the owners of private property through their interpretation of the constitutional guarantees forbidding Congress (Fifth Amendment) and the states (Fourteenth Amendment) to take "property" without "due process of law." In the earlier days, "property" was identified with physical assets; and "taking property" meant taking title and physical possession or seriously interfering with physical possession and use. "Without due process of law" originally meant without the traditional formal legal procedure, but soon also became synonymous with "without just compensation."[11] Accordingly, in the *Slaughter-House Cases*,[12] the Supreme Court by a majority ruling held that the city of New Orleans had not deprived independent butchers of their "property" when it granted a monopoly of the slaughtering business to a single, specially licensed corporation. The butchers still retained title to and possession of their premises, and they therefore still retained their property, even though its value had been greatly impaired by their legal inability to put it to a profitable use. Similarly, in *Munn v. Illinois*,[13] the Minnesota Legislature was held not to have taken "property" in the constitutional sense when it fixed maximum rates of charge for wheat-elevator service. The warehouse owners still retained their warehouses, and they were hence not deprived of their property, even though they were compelled by statute to charge rates which, in later days, would be called "confiscatory."

But beginning perhaps with the earlier *Minnesota Rate Cases*,[14] the Supreme Court began to change its concept of property, first by intimating, and then actually by holding, that certain acts of government which destroy or reduce the value of a business, such as a railway business, constitute a taking of property, which may not be done, at all events not without "due process of law."[15]

[11] It will thus be seen that even the earliest legal concept of property did not literally identify "property" with tangible things. It merely closely associated and confused the two. Property meant property rights, but the rights that were recognized were either those of a traditional formal nature, such as legal title to land, or else were those which could be pictured in physical terms, such as the right to undisturbed physical possession.

[12] 83 U.S. 36 (1873).

[13] 94 U.S. 113 (1876).

[14] Chicago, Milwaukee & St. Paul R. Co. v. Minnesota, 134 U.S. 418 (1890).

[15] Even today the Supreme Court leaves one uncertain as to whether its rulings protecting public utilities against "confiscatory rate regulation" are to be con-

A somewhat parallel, though less marked, change has taken place in condemnation law, where the courts have enlarged the meaning of a "taking of property" so as to give a private owner compensation for certain losses for which he could not formerly have recovered, since they were not obviously identified with the value of those tangible things to which the condemner takes title. In the condemnation cases, however, the earlier and more restricted viewpoint still persists to a much greater extent than in the rate cases. For the courts continue to make an important distinction between property that is "taken" (for which compensation must be paid under the "just-compensation" clause of the Constitution), and property values or personal values that are incidentally destroyed by the act of the condemner although they are not deemed to have been "taken" by him. In the cases which involve the protection of business good will—protection against unfair competition, against a violation of agreements between businessmen not to compete within limited areas, against infringement of trade names, etc.—the courts began to revise their concept of property at an even earlier date. They did so by recognizing property rights that would formerly have gone unprotected because they could not be identified with title or with rights of exclusive possession in specific, external objects.

The changing nature of property, as conceived by our courts and as reflected in the cases to which Commons refers, has had a vital bearing on the scope and theory of judicial valuation. In the first place, it has added new occasions for court-made valuations that did not exist at an earlier day. An example is that of rate-making valuation, which is made necessary by the newer viewpoint of the Supreme Court as to what constitutes a "taking of property." In the second place, it has forced the courts to face the problem of valuing many so-called intangible assets which they seldom had occasion to value under earlier law because of the limited extent to which these assets were deemed to constitute property. The multiplication of cases requiring the valuation of business good will illustrates this point. In the third place, it

strued to mean that such regulation deprives the utility owners of property, or else that it deprives them of property "without due process of law." The current legal doctrine that a utility has a right to charge such rates as will yield a reasonable return on "the fair value" of its property would seem to suggest the first interpretation. For it would seem to imply that any reduction in the value of the property resulting from a commission's action in reducing rates, is a "taking of property," and that this in turn is *ipso facto* "without due process of law." In the rate cases, it is difficult to discover that any action by government which a court deems to be a "taking of property" is nevertheless a taking *with* due process of law. On this point see R. L. Hale, *Valuation and Rate Making* (New York, 1918), Chaps. 1 and 3.

has often resulted in a shift from tangible assets as the subject of valuation to intangible things, such as an entire business enterprise distinguished from the sum of the physical assets of that enterprise. This is illustrated by the development of the so-called unit rule for the taxation by states of property of corporations doing business in more than one state. According to this method of taxation, the value of the entire enterprise, including good will and other intangibles, is first ascertained, and a portion of this total value is allocated by some arbitrary method of apportionment to the particular state which is imposing the tax. The Supreme Court has sustained this basis of tax assessment as against the objections of counsel for the taxpayers, who have insisted that a prorated value of an entire business enterprise, such as that of an express company or a railway company, must necessarily include the value of good will, which (counsel have urged) is not property in the accepted meaning of a law imposing a tax on "all property"[16] located in the state.

The same point of view which has led the courts to approve *higher* valuations in the unit-rule cases than their earlier notions of property would have permitted, has led them in other cases to adopt lower valuations. This is illustrated by the *Boston Chamber of Commerce* case,[17] in which the city of Boston had condemned land for a public highway. The fee of the land was owned by one party, but an easement of access was held by another party. These two parties joined in a plea that the total compensation be based on the value of the undivided fee in the land, and stated that they had agreed among themselves as to the division of the award. As a matter of fact, however, a valuation of the land "as land" (that is, as if it had been owned in unrestricted fee) would have resulted in an award exceeding the total loss suffered by the owners of the divided interests. This was true because the holder of the easement would have continued to enjoy access to the land even after it had been converted into a public highway. The Supreme Court upheld the city's contention that in this case only the value of the fee subject to the easement, and not the value of the land "as land," should measure the liability of the condemner. It thereby drove a wedge between property construed as a particular and limited

[16] Adams Express Co. v. Ohio, 165 U.S. 194 (1897), 166 U.S. 185 (1897). In this case the company contended that the only property which it owned in Ohio was its tangible assets composed of horses, wagons, etc. This contention was supported by four dissenting justices, who expounded the early concept of property which identifies or confuses it with physical things having a definite physical location. See Commons, *Legal Foundations of Capitalism*, pp. 172 *ff*. Also our Chap. XIX, at pp. 654–657.

[17] Boston Chamber of Commerce v. Boston, 217 U.S. 189 (1910).

interest in a physical object, and property as confused with the object itself.

Finally, one may note that the newer concept of property, which centers attention in opportunities and expectations of income rather than in physical things, is gradually leading to a correlative change in the concept of value even in those cases where the courts still speak of physical objects as the subject of valuation. Because the courts have had to face, with more and more frequency, the necessity of valuing many intangible assets, such as good will and franchises, the values of which are so obviously based on a capitalization of expected earning power, they are becoming more clearly aware of the fact that even *tangible* assets derive their value from the income which their possession makes it possible for businessmen to secure. If good will has value to the business that has created it, or to someone else who contemplates buying it, only because and to the extent that it will aid them in earning money, why does not the same thing apply to steam engines, houses, merchant ships, and electric-light plants? If a public-utility franchise must be valued under a special franchise tax by a capitalization of the income which the utility derives from it, why should not the value of the physical plant of this same utility be likewise determined by earning power for the purposes of an assessment under a general property tax? There is no essential difference between the two types of value. But in the case of the good will or of the franchise, the courts are compelled to break with popular tradition which associates property with physical things, and which therefore associates property values with the historical or reproduction costs of these physical things. The self-contradictory notion of "physical value" does not confuse the courts in the franchise cases or in the good-will cases because there is nothing physical with which the value can be confused. This growing experience of the courts with the valuation of intangibles is gradually destroying the illusion of a "physical value" even with respect to tangible assets. But the process of education is a slow one, and the tendency of the courts to break away from the notion of a "physical value," or of an "intrinsic value" based on past costs rather than on future opportunities, is still in a transitional stage.

PART II

METHODS OF VALUATION

CHAPTER VI

METHOD OF VALUATION AS DEPENDENT ON MEANING OF VALUE

At the beginning of Chap. II we noted that the two basic problems of valuation theory are, first, to define "value" in such a way as to make the term acceptable for the purpose at hand, and, second, to determine the data and technique by which the amount of this value may be estimated in terms of money. In a valuation conducted under the auspices of a court, the first of these problems is treated as one of substantive law, whereas the second is treated as one of evidentiary law.

All the preceding chapters of this treatise have centered attention on definition, with only such incidental reference to the problem of "proof" or "evidence" as has seemed necessary in order to make clear the very concept of value. We must now reverse the procedure and consider the methods of *estimating* value. But since "value" means so many different things at different times, one must always bear in mind the effect of its assigned meaning on the relevance of the data that suggest themselves as evidence. The nature of the relationship will be discussed in this transition chapter.

How the Meaning of Value Affects the Problem of Evidence.

Several illustrations will make clear the fact that different concepts of value require different methods of valuation. Suppose that, under an inheritance tax, assessors are required to determine the value on a certain date of ten shares of the capital stock of the Pennsylvania Railroad, which form part of the taxable property of a decedent's estate. If this value were construed by a legislature or a judge to mean "market value" *defined* as the arithmetic average between the high and the low quoted prices at which the stock had been sold on that day on the New York Stock Exchange, a determination of these two prices would complete the data necessary for the appraisal. All other facts or opinions about the security, such as the quoted prices of the stock just before or just after valuation date, or such as the question whether the prices on that date were "representative" or "manipulated and fictitious," would be literally irrelevant.

But if the value of the shares were interpreted to mean "market value" *defined* as the price at which the stock might have been

liquidated on that date, a finding of the high- and low-price quotations for the day would not be final Quite possibly, had these specific shares been offered for sale, they would have commanded neither the one price nor the other, but some intervening price. Cognizance would also have to be taken of the fact that ten shares of stock are treated as an "odd lot" on the New York Stock Exchange and are generally salable at a fraction of a point below the prevailing prices of hundred-share lots. Hence, an element of speculation enters into the appraisal, calling for the use of inferences as to what this particular block of stock might have been sold for, based on data as to what other lots of the same stock actually did sell for during the day in question.

Suppose, now that the "value for the purposes of the case" were taken to mean neither one of these two kinds of current market value, but rather "intrinsic value" in the investment analyst's sense. In that event, still a different technique of appraisal would be called for, and one subject to a much greater margin of error. The appraiser might *start* with the hypothesis that intrinsic value is measured by current price quotations, and he might even accept this hypothesis as valid for his purposes in default of conflicting evidence. But he must at least be alive to the possibility of discovering a measurable discrepancy between market price and intrinsic value. He might conclude, for example, that the price quotations of last week or of last month are a better index of intrinsic values than are the current ones, since the earlier quotations were apparently not influenced by a corner in the stock that is now pending. Or he might even resort to a kind of dead reckoning whereby he estimates intrinsic value by capitalizing the prospective earnings or dividends per share.

The bearing of the concept of value on the problem of evidence may be illustrated by another example. In a public-utility valuation for rate-making purposes, if the "fair value" of the physical property were defined, as a matter of law, as spot reproduction cost minus allowances for depreciation, the whole question would settle itself as soon as the amount of this cost and the proper allowance for depreciation had been determined. Original cost, capitalized earnings, amount and market values of outstanding securities, and all the other data that are so frequently urged as tending to prove value, would be literally beside the point, except perhaps as furnishing indirect clues as to reproduction cost or to depreciation. But if "fair value" in a rate case were defined as such a price as the property would command in an actual sale, between a company that now owned it and a company that wanted to buy it, then the appraiser would have to take into account all facts and opinions about the property that would guide businessmen in making

a trade of this nature. Reproduction cost would then be entitled only to such weight as might be accorded in the market for utility properties.

One could continue indefinitely with case after case, illustrating how the problem of *estimating* value is affected by the problem of *defining* it. Proof as to the *market* value of an unmarketable residence is not satisfactory proof as to the value that the owner himself attaches to the residence. Proof as to how the owner *does* value the property is not conclusive proof as to how he *would* value it if he were a reasonable or intelligent owner. Proof as to how he reasonably valued it 5 years ago is not acceptable proof as to how he would reasonably have valued then, had he been gifted with foresight equivalent to the hindsight available to the present appraiser. A finding that an accountant has properly valued the good will of a business at $1 for accounting purposes is not proof that a businessman would intelligently value the good will at this nominal price for the purpose of a purchase or sale. A conclusion that the fixed assets of a business are properly valued at original cost for the purpose of calculating depreciation, does not of itself justify the inference that original cost is the proper basis of valuation of the same asset for other purposes. And so on.

Theory of Proof Confused by Ill-defined Concepts of the Thing to Be Proved.

Even in the literature of those professions, including accountancy, investment analysis, and commercial appraisal, which specialize in the valuation of property, the discussion of the technique or method of estimating value often suffers from the lack of a clearly expressed concept of the value that is sought for. Accountants, for example, say many things about measuring "value to the going concern" without adequately defining that elusive term; and real-estate appraisers speak of distinctions between "real value" and mere market price without making clear to the reader just what distinctions they have in mind. But partly because most judges and lawyers are not value specialists, and partly because the purposes of legal valuations are so numerous and complex, this confusion between the problem of defining value and the problem of estimating it is most serious in the law. The reader of the reported opinions finds it impossible to discover from the formal definitions and explanations of value, concepts sufficiently definite to enable him to explain or criticize the rulings on evidence by reference to the stated objectives.[1]

[1] This point is repeatedly stressed in the chapters in Part III, on valuation for specific legal purposes. See also Chap. X, noting the serious confusion as to the

Even when value is defined by statute or by common law in terms of *market* value, this difficulty is serious enough. For the importation of vague ideas of *reasonableness* or of *normality* prevents the appraiser from taking market phenomena as mere cold facts and requires him to pass judgment upon them by reference to standards of fairness or of stability that are not amenable to scientific definition, and on which no person can qualify as an "expert." In consequence, the procedure of estimating "market value," and not merely the task of formal definition, raises questions that are really those of substantive law even though they are classed by orthodox jurisprudence as questions of evidence.

But it is primarily in those valuations where the law itself declines to apply a market-value standard that the confusion between evidence of value and value itself is most critical. In the chapters on public-utility valuation for rate-making purposes, we shall note that much controversy has arisen as to the relative weights that should be given to original cost and current replacement cost as indices of the "fair value" of the property. The lower court opinions reveal two schools of thought on this issue, one of which assigns no weight whatever to original cost except as a mere check on fallible expert testimony as to reproduction cost, whereas the other treats original cost as deserving weight in its own right, on grounds of the equities of the case. This conflict among the courts themselves as to the significance of original cost in public-utility valuations is not due to any mere difference of opinion as to what form of detective work is best designed to reveal the "true value" of the property. It is due rather to the failure of the United States Supreme Court to define this value with even such rough, workable approximation as is required in order to make possible an intelligent approach to problems of evidence.

The same necessity of redistinguishing between problems of substantive law and problems of evidence presents itself, though in somewhat less obvious form, in legal fields other than in rate making. When the New York Court of Appeals recently held that an elevated-railway company was entitled to a compensation for its condemned Forty-second Street spur which included an allowance of the *original cost* of acquiring its easements of air, light, and access,[2] its decision was per-

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significance of depreciation as an element detracting from value, resulting from the lack of a clear definition of value itself (at pp. 180–183).

[2] Matter of City of New York (Manhattan Ry. Co.), 265 N.Y. 170, 192 N.E. 188 (1934), *aff'd sub nom.*, Roberts v. City of New York, 295 U.S. 264 (1935), discussed *infra* p. 427. In affirming the award, the United States Supreme Court

haps defensible. But the award was justifiable, if at all, not on the ground that original cost even roughly measured what the easements were worth many years after their acquisition, but rather on the ground that "value of the property" was, in this particular case, an unjust basis of payment. Indeed, Judge Pound came very close to conceding this point in his prevailing opinion. But the New York Court of Appeals is often less traditionally minded than are most American courts, and the more typical opinion would have beclouded the issue by talking wholly in terms of *evidence*. Indeed, even Judge Pound's opinion is not completely free from this confusion.

Even under the law of inheritance or estate taxation, which has adhered more strictly to a market-value appraisal than have most other branches of the law, many of the disputes as to the measure or "proof" of value are really disputes about substantive law. In the appraisal of actively traded-in securities, for example, the practice of various jurisdictions differs as between the acceptance of current price quotations on the precise date of decedent's death and the acceptance of a "fair market value" based on a range of quoted prices before and after this date. Each of these two methods of valuation has its own practical merits and its own defects, and experts would probably disagree as to which is the more desirable. But the disagreement is not due to a mere dispute as to which method secures the closer approximation to some third thing which all the experts have in mind as constituting "fair market value." The very *meaning* of "fair market value" as an acceptable tax base is at issue.

Confusion Arising from the Fact That Evidence of Value, Like Value Itself, Is Often Stated in Terms of Dollars.

Many of the facts and opinions about property that are customarily recognized as probative of its value cannot be expressed in terms of dollars. Some of this evidence is not even expressible in quantitative amounts, such as evidence that a condemned office building is located on the corner of Forty-second Street and Fifth Avenue, New York City. Other evidence is given only in vaguely quantitative terms, as would be opinion testimony that, in all probability, a condemned tract of farm land would soon have become available for business premises.

But many of the more significant evidentiary facts or opinions about the property can be expressed in terms of dollars and can be presented in such a way that they suggest themselves as possible direct measures

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suggested that the state court might have been overgenerous in valuing the easements at original cost.

of value. Thus, in the appraisal of a residence property, proof may be offered that the original construction cost of the premises was $10,000, that under prevailing market conditions a similar property could be built or purchased for $15,000, that capitalized rent value amounts to $12,000, and that the owner recently declined an offer to purchase the property for $13,000. Any one of these figures might possibly be seized upon by a judge or jury as measuring the value of the property, and even an expert appraiser might choose one of them in preference to the others or might report a value based on a compromise figure.

The development of the evidentiary data into shapes that will make them acceptable as measures of value is an essential part of appraisal technique. But it is a difficult and hazardous task, since it involves inferences that may be unwarranted; and it is a distinguishing mark of the true expert that he is always seeking correctives and rebuttals for any tentative assumptions that a given property is worth what it did or would cost, or what it recently sold for, or what it has earned per annum multiplied by a conventional number of years' purchase, and so forth.

The same general procedure of inferring the value of property from data that, with or without correctives, may be assumed to *measure* this value is adopted in appraisals made by a court. Even the technical legal rulings on evidence, such as those guarding against mere hearsay or those excluding estimates of future prospects so wildly speculative that they can hardly be intelligently prophesied, correspond to the self-imposed working rules of a careful appraiser.

For a number of reasons, however, there is a fairly marked tendency on the part of a tribunal, in many types of legal appraisal, to take for granted a closer correspondence between crude indices of value and value itself, than an expert appraiser would be willing to assume. In real-estate valuation, for example, the costliness of the structure is likely to receive more respect from a judge or jury than it would receive from a competent appraiser; and the functional adaptability of the structure to the purpose which it is serving is likely to receive less weight. In general property taxation, replacement costs are often given dominant weight despite the fact that the property is obviously not worth replacing. And in the measurement of fire-insurance losses, there is a reluctance on the part of the courts to deduct from replacement cost new those drastic allowances for depreciation and obsolescence that a skillful buyer of real property would deduct. In the taxation of corporate franchises in New York, there has been a fairly regular practice of valuing the franchise by capitalizing the excess corporate earnings at the fixed rate of 6 per cent—a practice obviously out of line with the procedure of an investment expert who uses the

capitalized-earnings method as a basis of valuation.[3] The chapters in Part III of our treatise, on valuation for specific legal purposes, contain numerous other illustrations of this legal tendency to adopt fallible forms of evidence as measuring the value of property. To be sure, the tendency is by no means universal in the law; and a contrary practice may be found, say, in the valuation of securities under the Federal income tax, where the Board of Tax Appeals has repeatedly declined to make use of rigid formulas. But the former tendency is sufficiently prevalent to require notice.

Several reasons suggest themselves as to this partial confusion in the cases between fallible evidence of value and value itself. One of them is that the courts are not experts in value theory and are hence not sufficiently aware of the dangers of such inferences. This charge of inexpertness could be made even more obviously against a jury, when the trial is by jury. Another explanation is that the courts are well aware of the dangers of such inferences, but that they feel compelled to make or encourage them in order not unduly to prolong the task of appraisal. Such a rationale would have special force in tax assessments, where the courts have recognized that crude, wholesale methods of assessment may be necessary in order to permit the assessors to finish their jobs. But it is even invoked in condemnation cases, where a painstaking appraisal is required, but where nevertheless some courts have frequently refused to admit collateral evidence of value, such as sales of different property, on the ground that the data would confuse the tribunal and unduly prolong the trial.

In several important fields of law, there is still another reason why unreliable evidence is often accepted as if it really measured value—namely, that the so-called evidence is sometimes a better "value for the purpose of the case" than the most accurately estimated "true value" would be. This point has already been mentioned in an earlier chapter,[4] but its importance justifies further illustration in the following section.

Situations Where "Evidence" of Value Is Superior to Value Itself.

The fact that the proper objective of a legal "valuation" is not always to determine "actual value" may first be illustrated by two situations where this fact is well recognized as a matter of doctrinal law. Under the corporation laws of most states, corporations are forbidden to issue stock with a par value except in exchange for an

[3] See *infra* pp. 262–264, 598–611.

[4] At p. 77.

equivalent in money or money's worth, "in meal or in malt."[5] Ostensibly full-paid stock that was actually issued for less than par, is treated as "watered stock," and under certain conditions, creditors of the corporation may hold the individual stockholders liable for the unpaid balance. But it is also the statutory or common-law rule in most jurisdictions that, where stock has been issued for property, the value placed upon that property by the directors must be accepted as final, provided that it has been estimated in good faith. Consequently, a mere proof by creditors of factual overvaluation is not enough. There must also be proof that the overvaluation was "fraudulent," which is often interpreted to mean that it was "unreasonably" high. Obviously, then, the object of the valuation is to determine, not what the property was actually worth when the stock was issued, but rather whether the valuation accepted by the directors was *reasonable.*

Still another illustration of a frankly recognized difference between the problem of determining "true value" and the problem of finding value "for the purposes of the case" may be found in the statute laws governing standard fire-insurance policies.[6] These laws stipulate that the recoverable loss shall be limited to an amount equivalent to the "value" of the insured property. But some of them, such as that of New York, proceed to state that this value may not in any case exceed current replacement cost minus depreciation. Under the guise of what, at common law, would be regarded as a ruling on evidence, the statute really defines "value" as the lesser of two figures, value or depreciated replacement cost. The limiting factor (replacement cost) is apparently inserted, not merely for the purpose of preventing the award from exceeding the "true value" of the property, but also for the purpose of restricting standard fire-insurance policies to insurance against those damages to which the owner of the property would be subject by virtue of his necessity of replacing the destroyed structure. Other risks may best be insured against by special forms of insurance, such as "use-and-occupancy" insurance.

Turning now to the less overt acceptance of so-called *evidence* of value as constituting, in effect, the very *standard* of value, we may first take note of public-utility valuation for rate-making purposes. As a basis of rate control, value, in any sense in which either economists or courts have defined the term, is utterly disqualified.[7] This point is recognized, not only by those economists who prefer the "prudent-investment" principle of rate making but also by those who defend the

[5] Chap. XXIII.
[6] Chap. XV.
[7] Chap. XXX.

"replacement-cost" principle. The latter experts favor a replacement-cost rate base, not on the ground that this cost measures present value—which it clearly does not do in the case of a monopoly—but rather that it is entitled to acceptance *on its own merits*.

The courts, however, still persist in their fallacious assumption that the "value of the property used and useful in the public service" is a sound basis of rate control; and they still *purport* to give weight to estimated replacement cost, along with other "elements of value," merely in so far as this cost may be taken as a clue to the "real value" of the property. Had they really lived up to this verbal doctrine, following it through as a skilled appraiser would do in determining the commercial value of the property, their action would have completely defeated the attempt of the government to regulate utility rates. In fact, however, they have partly corrected their initial fallacy—the fallacy of adopting value as the rate base—by resorting to countervailing errors in their methods of appraisal. They have generally rejected the capitalized earning power of the business in favor of appraisals based on original cost or replacement cost, thereby securing a rate base, the very validity of which has depended on its use of a cost standard *instead of* a value standard.

This same resort, conscious or unconscious, to a countervailing fallacy, whereby the courts accept "evidence of value" which constitutes a good measure of the equities of the case although it constitutes a poor measure of value, is to be found in other fields of law than that of rate making. For example, in many types of valuation designed to measure the income derived from property, the courts have quite properly accepted the accountants' book values, based on original cost less depreciation,[8] despite the fact that these figures do not reflect the present value of the property and that they would not be accepted by the courts for other legal purposes—say, in the calculation of an award under the law of damages. Under the Federal income tax, inventory valuations based on "the lower of cost or market" are regularly approved,[9] although they do not reflect what the inventories are worth and have been rejected, for this very reason, in inheritance taxation or in the measurement of recoverable damages.

In property taxation, assessments based on the original cost or the estimated replacement cost of the property have often been allowed to stand despite clear evidence that the commercial value of the property was far less. Indeed, a plausible, though not conclusive, argument can be made for the view that the replacement cost of build-

[8] Chaps. XXVI and XXVII.

[9] *Infra* pp. 1012–1015.

ings and structures is a better standard of tax assessment than the most accurately estimated commercial value.[10] In the taxation of interstate public-utility properties under the unit rule, the property as a whole has been valued at its estimated commercial value; but the allocation of a share of this unitary value to any one state has been based on rules of evidence which would be quite indefensible were it not for the fact that the portion of the property lying within any one jurisdiction is properly assessed at a figure which does not represent its "true value."[11] Here again, the "evidence of value" is acceptable, not because it is good *evidence*, but because it constitutes a reasonable tax base in its own right.

In short, then, when we say that so-called "evidence of value" is often a better basis of valuation than value itself, we mean that, in many legal appraisals, the law is verbally wrong in stating that the object is to determine what the property is really worth, and that it tacitly corrects this error by accepting one of the proffered items of evidence—say, original cost, or depreciated replacement cost—as constituting a better legal standard than would the most accurate estimate of the value of the property.

Compromise Rules of Evidence Resulting from Compromise Standards of Value.

We have already noted a tendency on the part of the courts, in various fields of law, to accept valuations based wholly or largely on crude "measures of value" (such as original cost, replacement cost, or recent earnings capitalized at 6 per cent) which would be deemed utterly unreliable by a trained, unbiased appraiser. This tendency may be due partly to a preference for relatively simple methods of appraisal, and partly to a tacit recognition that a fallible "measure of value" is sometimes preferable to value itself as a standard of legal conduct.

Seldom, however, has the frequent preference for a single "measure of value" gone so far as to result in crystallized rules of evidence, such as would apply if a court were to hold that, in a valuation for the purpose of measuring fire-insurance losses, buildings *must always* be valued at prevailing replacement cost minus an allowance for depreciation calculated by the "straight-line" method. "Conclusive presumptions" that property is worth whatever amount is indicated by certaia restricted data are rarely, if ever, indulged in; and even such terms as

[10] *Infra* pp. 459–460, 520.

[11] *Infra* pp. 677–691.

"rebuttable presumptions" or "prima facie evidence of value" are used sparingly. Often the student of legal appraisal runs across a "line of cases" which adheres to a single basic method of valuation, only to find some later case in which a court has upset the precedent by introducing a new factor or by refusing to be "bound by formulas."[12]

To a considerable extent, this refusal of the courts to accept any one "measure of value" as final is in harmony with good practice in professional appraisal.[13] Yet, in some fields of law, the courts have favored composite or compromise methods of valuation which would be rejected by appraisal experts as failing to represent that single "fact" which is supposed to be sought for in an appraisal—the "actual value" of the property on valuation date. The most striking examples of these compromise valuations are to be found in the public-utility-rate cases, where most courts, including the Supreme Court, have declared that, in the valuation of a public-utility plant, simultaneous "consideration" must be given both to original construction cost and to prevailing replacement cost.[14] On this point most appraisers would doubtless agree with Judge Learned Hand, who ridiculed the compromise standard as having no legal or economic significance.[15] A similar eclecticism, quite unsupported by modern appraisal theory, can be found in legal valuations for other purposes—for example, in tax-assessment cases, where there has been a tendency to approve valuations of business structures based on estimates of replacement cost, except when such valuations are deemed to be *utterly* belied by the test of capitalized earnings.[16]

[12] As in the New York cases seeming to hold that the value of a building or other structure, when used as a measure of recoverable fire insurance, means, in effect, replacement cost minus an allowance for mere physical depreciation—cases the precedent of which was broken by McAnarney v. Newark Fire Insurance Co., 247 N.Y. 176, 159 N.E. 902 (1928). See *infra* pp. 384–392. In its rate cases culminating in McCardle v. Indianapolis Water Co., 272 U.S. 400 (1926), the Supreme Court seemed to be coming close to identifying "fair value," in effect though not in words, with spot reproduction cost minus an allowance for observed depreciation and plus certain allowances for intangibles. But later cases again emphasized original cost. See *infra* pp. 1123–1124. Under the Illinois capital stock tax the Illinois courts have consistently upheld assessments based on a "stock and bond" valuation. But in a much litigated case in which the taxpayer challenged his assessment in a Federal court, this court tested the fairness of the assessment by a capitalized-income method. See *infra* pp. 569–572.

[13] But in a later chapter we note a significant contrast between the appraisal technique of the courts and the technique of modern appraisal theory. *Infra* pp. 1181–1187.

[14] See *infra* pp. 1118–1121.

[15] His position is noted *infra* p. 1120.

[16] See *infra* pp. 490–492.

While this apparently unwarranted judicial fondness for compromise "measures of value" may possibly be due merely to an inexpert grasp of the methodology of appraisal, we attribute it largely to a tacitly accepted compromise standard of value itself—to an interpretation of "fair value" to mean, not one simple thing, but rather a resultant of several factors that seem to have a bearing on the equities of the case. So, when a court holds that the value of a utility property for rate-making purposes is somewhat higher than original cost and somewhat lower than replacement cost, it may choose the intermediate figure because it feels that there is something to be said for an original-cost standard and something to be said for a replacement-cost standard. And so, when a court supports a railroad tax assessment based largely on the *costliness* of the property, merely *shaving* the valuation somewhat because of deficient earning power, it may be influenced by the conflicting arguments, both of them cogent,[17] in favor of assessments based on cost and of assessments based on commercial value. These are mere surmises on our part. But a close study of the cases justifies such surmises as the most plausible explanations of the courts' actions.

The presence, in the law, of compromise standards of value should surprise no one who considers how frequently similar standards are accepted by all people in their daily business conduct. An employer, let us assume, is deciding what wages to pay his stenographer and may think of the problem as that of paying what the services are "fairly worth." He finally agrees to pay $40 per week. But his decision is not based on any single criterion. Instead, it is influenced by such divergent forms of "evidence" as the current wages of equally trained stenographers, the length of service of his own stenographer, the fact that his partners have warned him to keep down office expenses, and the opposing fact that his stenographer has told him of her financial difficulties in putting her brother through college.

In the daily routine of living, most people, if they stop to think, will frankly concede that their decision to pay $40 a week for a stenographer, or $40 a month for a maidservant, is not based on a finding of any single "fact." But when judges put on their official robes, they enter into a conspiracy to ignore, or even to deny, the eclectic nature of their legal standards. So, traditional law still purports to regard "value of the property" as a definite "fact to be found," and relegates its compromise methods of valuation to the subordinate position of mere "rules of evidence."[18]

[17] For an argument in favor of tax assessments based on replacement cost, quite without reference to value, see *infra* pp. 459–460, 519–520.

[18] For further discussion of this point, see *infra* pp. 1089–1091, 1169–1173.

To the student of appraisal theory, the difficulty with these composite concepts of value is that they defy any attempt to build up a theory of proof, a technique of estimate, by reference to warranted inferences from known facts. The problem would not be hopeless if the ingredients in the composite standard of value were stated in fixed proportions; for example, if "fair value" for rate-making purposes were held to mean the arithmetic average of spot reproduction cost and original cost. But never are any such fixed ratios set by the courts in their formal definitions of value; and an appraiser or a judge who seeks a proper ratio under the guise of "weighing the evidence" is really attempting the unfinished task of defining value for the purpose of the case.

Conclusions.

The object of this introductory chapter on evidence or "proof" of value has been to emphasize the necessity of a fairly precise definition of value as a prerequisite to the intelligent discussion of the evidence. Evidence of one kind of value is often not good evidence of another kind, and the reported cases often leave the reader in the dark as to the nature of this thing called "value," of which they purport to be seeking proof.

The general nature of the distinction between evidence of value and value itself is well recognized by the courts, as it is by professional appraisers. But there is an apparent tendency on the part of some courts to confuse those forms of evidence that are expressed in terms of dollars with the value of the property, and to assume a closer correspondence between the two than expert appraisers would deem warranted.

This tendency is accounted for in part by the fact that the courts are under pressure to make use of cruder methods of estimating values than appraisers would employ if given adequate time and funds by their clients. But it is also due, in many cases, to a partial recognition by the courts that "value of the property" is not the most desirable legal standard in all those situations to which it is applied by orthodox law. In some of these situations, the data that are formally admitted only under the guise of "evidence" are really more appropriate measures of the equities of the litigant parties than would be the most accurately estimated "true value." This statement applies in most obvious form to rate-making valuations, and to certain kinds of valuation designed as steps in the measurement of annual income. But it applies in subtler ways to many cases in the law of general property taxation, of eminent domain, and so forth.

Indeed we may express the opinion that, were the courts in command of some miraculous appraiser who could instantly name the precise value of property, under any formal definition of "value" set forth by economists or lawyers, they would more often than not reject these "true values" in favor of some other figures which would seem to them to furnish a better basis for the settlement of the lawsuit. They would be quite justified in doing so. But it is unfortunate that the law does not frankly admit, what it tacitly recognizes, that "value" is a far more limited and less useful standard for the settlement of disputes about property than one might infer from the multitude of legal tasks that it is supposed to perform.

CHAPTER VII

METHODS OF VALUATION: I. GENERAL THEORY; II. ACTUAL SALE PRICES AS MEASURES OF VALUE

The preceding chapter has stressed the point that, in legal appraisals, the problem of estimating or measuring value is generally confused by the incomplete definition of "value" as the "fact to be found." Substantive law is content to characterize the value under inquiry by a mere form of words, leaving questions of close definition entangled with questions as to the relevance and weight of the "evidence."

But even if this confusion were not present, and even if a court or an appraiser could turn to the task of "proving" value with all questions of definition disposed of at the inception of the trial, the appraisal of a given property at a given time and place would still be fraught with difficulty. This is necessarily true because, as will be noted later, valuations involve economic prophecies based on a complex and highly controversial technique of inferences from the known to the unknown.

In appraisals conducted under the auspices of the courts, this technique of inferences is governed by that more or less formal body of rules of trial procedure which is called "the law of evidence." Some of these rules, being generally applicable throughout the entire law or at least throughout the law of property, require only passing mention in a book on legal valuation. Others are peculiar to valuation cases and must therefore be treated in this study. But since the legally accepted methods of valuation differ materially with the different purposes of the appraisal, their detailed discussion is best reserved for the chapters of Part III, which consider these purposes separately. Thus, Chap. XVIII will note that the Supreme Court has sanctioned the use of the capitalized-earnings method of valuation when applied to public utilities for *tax* purposes, whereas Chap. XXXI will note that the same Court has rejected this method of valuation when applied to public utilities for *rate-making* purposes.

But while, here and there, the courts have adopted esoteric rules of valuation that are in conflict with the approved practice of the appraisal professions,[1] for the most part they have accepted the technique of

[1] Discrepancies of this nature are noted *infra* pp. 1181–1187.

valuation that has been developed by the professions themselves. Except in those cases in which they openly or tacitly adopt a concept of value different from that of the appraiser, their choice, say, between a valuation based on estimated replacement cost and a valuation based on a capitalization of earnings, is largely determined by their understanding of good practice among the experts.

Even the lawyer who is solely interested in a *legal* appraisal must therefore learn the methods of valuation that are used by the lay specialists, and must understand how these alternative methods may be attacked or defended in a specific case. With this object in mind, the chapters of Part II will consider in turn the four most usual methods of appraisal—those that base the valuation (*a*) directly on actual sales of the same property or of similar property, (*b*) on the actual cost of the property, (*c*) on estimated replacement cost with allowances for depreciation, and (*d*) on a capitalization of income derived or derivable from the property. By way of introduction, the following section of this chapter will say something as to the general theory of "proving" or estimating value.

But as our study concerns the valuation of all types of property, it must be confined to the general principles of appraisal and must omit many important details. When one recalls that entire monographs have been devoted to such narrow topics as the valuation of shade trees, and that large volumes have been published on such broader subjects as the valuation of ordinary real estate or of mining properties, one will appreciate the necessity of omitting from this survey a detailed discussion of technique. Indeed, only an appraiser who specializes in the valuation of a specific type of property is competent to deal with this technique.

One further restriction will govern the discussion that follows. Since it is impossible intelligently to discuss methods of valuation without reference to some assumed definition of value, we shall here take it for granted (unless a statement is made to the contrary) that the object is to estimate either (*a*) the market value of the property, defined as the price for which the property could actually be sold, or (*b*) the value of the property to the owner himself. If neither of these definitions is accepted, some of the points to be made in these chapters on methods are inapplicable.[2] But the two assumed value concepts are so funda-

[2] Many, perhaps most, writers on appraisal technique accept as their master concept of value what Babcock calls "justified selling price," sometimes called "intrinsic value." See *supra* pp. 24–29. Value as thus construed may differ both from market value and from value to a specific owner. Some couurt. however, have confused the concept of justified selling price with the concept of actual market value. In the following discussion of methods of valuation we shall occasionally refer to the special problem of estimating justified selling price.

mental that they furnish a background for the whole methodology of appraisal.

I. The General Theory of Appraisal Technique.

All of the various methods of valuation known to the appraiser make use of inferences from either or both of two sets of data—first, data as to the values that have already been placed upon property by other people; second, data as to the advantages that the property in question may be expected to confer upon an owner, present or prospective. In the first instance, the appraiser is simply a recorder or discoverer of values fixed by others; in the second instance, he is himself an estimater of values, an appraiser in the strict sense of the word.

Nearly all valuations require a resort to both types of inference, and literally all of them require resort to the first. But in certain simple appraisals the second is absent or almost absent. Assume, for example, the problem of determining the market value of 100 shares of United States Steel common on any day on which the New York Stock Exchange is open. In this case, value may be inferred directly from the current sale quotations. The price placed on the stock by the market determines, with only a trivial margin of error, the market value of the particular lot of stock in question, and the appraiser need not go through the hazardous process of inferring value from his own estimates of the future yield of the shares.

The same resort to other people's valuations may be illustrated by an attempt to determine the value of a homestead to its present owner. The simplest method of determining this value would be to ask the owner, possibly under oath, how much the property is worth to him. In fact, owners are generally permitted to express their opinion of property value in litigated cases. To be sure, an unsupported statement of this nature is properly accorded scant courtesy, not only because the owner's estimate may be unintelligent, but also because it is almost certain to be biased. But the latter defect may be remedied if it is possible to catch the owner in some action that may reveal his careful and honest opinion about the property. Shortly before valuation date he may have made a bona fide offer to sell the homestead for $5,000, an act that suggests, although it does not conclusively prove, that $5,000 is the upper limit of value. Or shortly before this date he may have declined a bona fide bid for the property at $3,000, an act which suggests a finding that the homestead was worth to him at least this amount.[3]

[3] The legal cases furnish numerous examples of attempts by one of the litigants to confront the opposing party with embarrassing claims as to value that it has

In all of these situations, which recur constantly in the legal cases as well as in professional appraisal, the work of the valuer is simply the work of a detective, in that his problem is to find out how the property is actually valued by other specific individuals or by the market. Even this feature of appraisal often requires skill and technical training, since it is not always easy to prove bona fide sales or bona fide opinions. For example, the question may arise whether the sales of United States Steel common can reliably be assumed to be such sales as are reported in the *New York Times* or the *Commercial and Financial Chronicle*, or whether the reported bids and offers of inactive stocks were actual or nominal, or whether the catalogue prices of the products of a manufacturing company express the real selling prices.

But the truly formidable task of appraisal commences when valuations placed upon property by other people cannot be used directly and uncritically as expressing the appraiser's finding of value. Here we come to the problem of appraisal in the strict sense of the term, to the necessity of going through a process of valuation rather than of relying entirely on the actions of other people who have already gone through it. This problem is most acute when some other value than market value is desired. The investment analyst who attempts to estimate the "intrinsic value" of a security is precluded by the very nature of his assignment from taking market quotations as final; and the appraiser who attempts to determine the reasonable value of a homestead to its owner cannot be content to record what the owner said that the property was worth, or even what the owner is shown to have actually believed that the property was worth.

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made in previous cases. Evidence of this type is often offered as "admissions against interest," and it is sometimes persuasive with a court. See, for example, an income-tax case, *infra* p. 1065, note 101, in which the witnesses were faced with an appraisal that they had previously sworn to for estate-tax purposes. In railway valuation it has been to the interest of the companies to claim high values for rate-making purposes and low values for tax purposes. See Chaps. XVIII, XXX. With a proper feeling of delicacy, the companies generally assign these two types of litigation to different attorneys. The daily press of Sept. 27, 1934, reported that counsel for the common stockholders' committee of the Middle West Utilities Company, which was still in process of reorganization, had asked the creditors the embarrassing question whether they would agree to sell their interests to the stockholders for the mere $18,000,000 which they themselves had claimed the property to be worth.

Of course the probative significance of these admissions against interest is not purely a question of evidence in a strict sense of that word. The previous claims may have been ridiculous; yet it may be argued that they should be accepted as establishing "value for the purpose of the case," in order to penalize attempts to take advantage of inconsistent valuations.

But even when market value in the strict sense of realization price is the accepted "fact to be found," it is only with respect to a few, highly marketable and standardized commodities that the question can be settled conclusively by reference to actual current sales. More often than not, there have been no recent sales of the property in question or of substantially identical property; and even if such sales have occurred sporadically, they do not constitute in themselves convincing evidence as to the price at which the owner could sell his property under market conditions prevailing on valuation date. The owner of a homestead may have bought his property a year ago for $10,000 in cash; but conceivably he could now sell it for only $5,000 on the one hand, or for at least $15,000 on the other hand. The appraiser of 50 shares of stock in a textile company may discover that 1,000 shares of the same issue were sold, 6 months ago, at 60; but aside from the possibility that market conditions have changed, this purchase may have been made by someone who was seeking the voting control of the corporation. Such control now being secured, the minority stock of the company may be unsalable save at a much lower price.

When faced with serious objections to the direct use of values already fixed by the market place as a measure of the present value of the property in question, the appraiser must try to bridge the gaps between the revealed market prices and the value that he must estimate. To be sure, he must still depend on market-fixed prices for his basic data, for no appraiser lives who could construct a whole system of property values by dead reckoning from his own processes of subjective valuation. But he must draw inferences as to the present value of the particular property by a less simple method than that of an assumed identity between this value and any given sale.

In the main, these inferences are made by the application of correctives to prices established by actual sales, so as to convert these prices into acceptable measures of the value of the property on a date when it was not in fact sold. Thus, if the appraiser cannot determine the present market value of an inactive security by reference to recent sales, he may start with sale prices established several months ago and may then add or subtract an allowance for the intervening trend in the market prices of similar securities. Or if he is valuing three shares of active stock, he may start with the current market price of a full lot, subtracting the usual spread between regular sales and odd-lot transactions. Or if he is estimating the market value of a tract of land on a street corner, he may consider the reported sale price of a side lot, adding to that price a standardized or estimated premium for corner-lot value. Or if he is seeking the market value of a shipment of wheat

in a rural community, he may take the current selling price in the nearest large city, deducting transportation expenses and so forth in order to equate the difference in "place values." In short, he bases his estimates of value largely on translations from actual sale price at one time to value at another time, or from the current sale price of one commodity to the current value of a different commodity, or from the current price of a commodity at one place to its current value at another place, or sometimes from the value of the property in one sense to its value in another sense.

Some of the accepted methods of appraisal do not seem, on their face, to involve inferences based on actual sales. When the value of corporate stock is estimated by the so-called capitalized-earnings method, the appraiser seems to be abandoning actual sales in favor of his own estimate as to what the sale price should or would be. And when a building is valued at its estimated replacement cost, there would seem to be no reliance on actual sales. In fact, however, both of these methods of valuation make use of established sales, although the technique of this use is peculiar. As to the former method, the reported earnings of the company are derived from its actual sales of commodities and services. Moreover, the rate at which the annual earnings, realized or estimated, are capitalized is a rate selected by the appraiser because he finds, as a matter of experience, that business properties have actually been bought and sold at so many times their annual earnings. As to the replacement-cost method, actual sales must be relied upon to furnish the data for estimating this total cost, which is based on the prices that would have to be paid for the bricks, mortar, labor, etc., that go into the structure. But the theoretical defense of an inference that the replacement cost of property measures the value of that property is somewhat complicated, and we defer its discussion to the special chapter on that type of evidence.

Does Valuation Involve Prophecy?

The statement made at the beginning of this chapter, that valuation necessarily involves prophecy or forecasting, requires some comment, since it has been challenged by several writers on appraisal. The life of a prophet is not a happy one, and professional appraisers are naturally reluctant to admit that their opinions on value must stand or fall by the verdict of history. Some of them have therefore insisted that their task is simply to find what the value of the property *now is*, not to foretell what this value may be in the future. This point of view seems to have support from the conventional language of the courts, which often talk about "proving value" as one might prove yesterday's

closing sale price of a listed security. As Professor John H. Gray once remarked in referring to public-utility valuations, the courts have referred to the problem of "finding" value as one might refer to the problem of finding a lost dog.

It is true that value may be arbitrarily defined in such a way as to make it a cold "fact to be found" in the same sense in which any historical event may be treated as a fact. Certainly, for example, if a court were to define the value of a listed stock as the mid-point between the opening and closing price of that stock on valuation date, no necessity of forecasting would arise in a trial taking place thereafter.

Only rarely, however, do the courts resort to these artificial definitions, which are never accepted by the appraisal profession. Appraisers, to be sure, rightly insist that a subsequent sale of property at a price different from its appraised value does not prove that this latter estimate was necessarily wrong; quite possibly the sale price was wrong. But a determination of a *fair* selling price requires a forecast of the prospective services accruing to an owner of the property; and even an attempt to state present market value, fair or unfair, is an attempt to *predict* at what price the property would presently be sold if the owner should undertake to sell it.

The undeniable fact, however, that the process of valuation is one of prophecy does not necessarily mean that a value once arrived at by this fallible process is wrong simply because the prophecy has been belied by subsequent events. The term "value," both in law and in business, is often used as a synonym for a "reasonable valuation" made in the light of such forecasts as can be made on valuation date. When so construed, value would be definitely established, and not merely predicted, if the appraiser's forecasts could be shown to be the most reasonable ones. Here, by very definition, the amount that a property is worth *is* the amount that people reasonably think that it is worth. Justice Holmes stated this point clearly when he spoke for the Supreme Court in declining to upset a valuation of a life estate, based on the use of standard mortality tables.[4] Although the life tenant had subsequently died long before her "probable" date of death as assumed from these tables, the Court held that this embarrassing event did not affect the value of the life interest on the earlier date of the testator's death. "The value of property of a certain date," said the Justice, "like all values, as the word is used in law, . . . depends largely on more or less certain prophecies of the future, and the value is no less real at that time if later the prophecy turns out to be false than when it comes out true."

Ithaca Trust Co. v. U.S., 279 U.S. 151 (1929). See *infra* p. 743.

In the chapters on valuation for specific legal purposes, we note various occasions on which the courts have not adhered strictly to this concept of value, and where they have accorded weight to hindsight data that would be disregarded if value were completely identified with a reasonable *estimate* of value as of valuation date. But even if one accepts the logic of Justice Holmes' remarks, it does not follow that value can be "proved" with any such approach to accuracy as the word "proof" would seem to indicate. In the appraisal of unmarketable properties, skilled and unbiased appraisers are often widely apart in their estimates, and there is no reason to suppose that the procedure of a trial has the magic effect of selecting the best estimate and rejecting all the others. Even the familiar doctrine of civil cases—that "proof" means merely establishing the fact "by the preponderance of the evidence," as distinct from "proof" in criminal law, which requires establishment of guilt "beyond a reasonable doubt"—greatly overstates the practicable attainments of a valuation. The only safe generalization about appraisals is that, however they are reached, they are almost certainly wrong by whatever standards of rightness the appraiser himself would recognize. We surmise that in the large majority of legal valuations, the errors are sufficient to do substantial injustice to one or the other of the litigant parties. This is inevitable though regrettable. But the law prides itself too much when it assumes that its elaborate system of procedure is capable of "proving value."

II. Actual Sales as Measures of Value.

The method of valuation which will now be discussed is given first place, sometimes to the exclusion of all other evidence, in the legal valuation of marketable forms of property. It invokes the use of actual sales of the same property, or of closely comparable property, as furnishing, with or without correctives, the measure of value. It is illustrated by the valuation of securities at current selling prices, or by the valuation of a tract of land at the price at which a neighboring tract was recently sold, or by the valuation of a railway enterprise at the sum of the current market prices of the company's outstanding stocks and bonds. We may consider its applicability, first to an estimate of market value, and then to an estimate of value to the owner.

Actual Sales as Evidence of Market Value.

The ambiguities of the term "market value" have already been discussed at length, and their bearing on problems of evidence have been noted. Here we shall assume that market value means the price at

which the owner might have sold his property under market conditions prevailing on valuation date.[5] The question arises, then, as to the bearing of *actual* sale prices on this *potential* sale price.

Despite the somewhat chaotic behavior of prices, especially during periods of unusual economic readjustments, experience has shown that, over relatively short periods of time, there is a tendency for prices of the same types of commodities approximately to repeat themselves. The fact that United States Steel common closed yesterday at 30 is a strong indication that the owner of an ordinary lot of these shares could sell them at the opening of the market today at approximately the same figure; and even the fact that a large office building was sold, a year ago, at $5,000,000 gives *some* ground for an inference that, if market conditions have not seriously changed, it could again be sold in the neighborhood of this figure.

Just why this law of price repetition exists is a question that has never been satisfactorily answered by economists. It is often supposed to be due to the tendency of buyers and sellers to agree in their calcula-

[5] A brief comment is called for on the relevance of actual sales in proof of a market value construed in two other senses. In Chap. III we noted that the term is sometimes used to mean, not the price at which the owner in question could sell his particular holding of the commodity, but rather the figure resulting from a multiplication of the current market price, per unit, of the type of commodity by the number of units that are under valuation. If, for example, the current Stock Exchange quotation for Pennsylvania Railroad stock is 40, as established by sales of 100-share lots, and if an investor owns 1,000,000 shares of this stock, his entire lot may be said to have a market value of $40,000,000, even though his block is so large that he could not dispose of it for more than $30,000,000. We have called this definition of market value, "imputed market value," to distinguish it from the strict definition whereby the property in question is valued at the price at which it could actually be sold. It has been accepted by some courts in various cases—notably, in the valuation of securities under the death taxes and income taxes. See *infra* pp. 716–719 and 1035–1040. When value is thus defined, it is measured directly by actual sales of ordinary lots on established markets. Indeed, one can hardly here speak of the sales as mere *evidence* of value; the sale price *is* the value per unit, by very definition.

Sometimes the courts identify, or at least confuse, the concept of market value with that of "*fair* market value," which is in turn identified with intrinsic value in the investment analysts' sense (*supra* pp. 24–29). See, for example, Strong v. Rogers, 72 F. (2d) 455 (1934), an income-tax case discussed *infra* pp. 1031, 1075, where a court held that the market price of stock prevailing during the boom days of 1929 did not measure its "fair market value" under the Federal Income Tax Law. Even here, the courts have indicated that an actual sale constitutes *evidence* of value, since they have accepted the popular assumption that the stock market is *usually* a fair index of intrinsic value. But the evidence is not deemed conclusive and is held in special suspicion during periods of the market that are deemed to be abnormal.

tions of the prospective advantages to be secured from the ownership of specific commodities. But it is more probably due in large measure to what economists would call the "irrational" tendency on the part of buyers and sellers to accept uncritically the values placed upon the commodities by previous buyers and sellers. In any event, the phenomenon is observable to a greater or less extent with respect to nearly all forms of property, and the appraiser relies upon its continuance. Just as an automobilist may assume that, because his car developed a speed of 70 miles an hour yesterday, it would develop about the same speed if tested again today, so the appraiser often assumes, with a far greater margin of error, that because the property was recently sold for $10,000, it could now be resold for about this same figure.

In valuations where market value is the objective, the courts quite generally admit recent sales of the very property in question, or of similar property, as evidence of value; and in the valuation of securities or of standardized commodities these sales are often taken as settling the whole question without more evidence. Even here the inference of present value from recent sales may be inaccurate, and a litigant usually has at least the nominal opportunity to disprove its validity and to establish a different value. But with all their defects, actual sales are generally a far more reliable index of market value than are any available alternative forms of evidence, such as estimates based on a capitalization of prospective earnings. They have the striking advantage of combining greater reliability with greater ease of ascertainment.

But only with respect to highly marketable property, and not always even there, is a court or appraiser justified in accepting uncritically the record of current sales as the measure of market value. The validity of an assumed equivalence between the market quotations and the value must at least be checked. Some of these checks may result in a decision to use one sale as strong evidence of value but to discount or completely ignore others. Thus, a so-called "forced sale" may be excluded on the ground that it was "not representative"—that is, on the ground that it does not indicate the price at which the property could be sold by someone who took due time and pains to secure the best market. Or a sale to someone who wanted the property for an unusual purpose might be ignored, on the ground that the owner of the property that is now being valued would hardly be lucky enough to discover another similarly necessitous buyer.

One of the problems that frequently arise in and out of court, is whether an appraisal based on sales should take into account only the most recent transactions, or whether it should be based on some average or range of prices prevailing for some time before or after the valua-

tion date. The advantage of the first method is that it secures the most up-to-date market prices, more nearly reflecting conditions as they exist at the time of the valuation. The advantage of the second method is that it may rely on the "law of large numbers" to prevent "unrepresentative sales" from having critical influence. There may be a greater probability that the average of twenty separate sales will represent the price at which the owner of the property could now sell it, than that the very last sale would represent this price. But we are getting now to a fine point of appraisal technique, which could be discussed intelligently only by experts in the valuation of special types of property. In some cases the price range may be better because it covers more sales; in other cases the shorter range or even the single most recent price may be better because it is nearest to valuation date. In the legal cases there is no uniformity of practice here, although the decided tendency is toward the acceptance of a somewhat wide price range. But one must remember that this width of range is sometimes chosen, not because it constitutes better evidence of the actual market value of the property on valuation date, but rather because it is supposed to reflect some "reasonable" or "normal" value implicit in the judicial concept of market value itself. A problem of substantive law thus arises under the guise of a problem in evidence.

In legal valuations, the most serious problems as to the use of sales as evidence of value occur in those cases where an objecting party to the dispute can present a forcible argument that for some special reason they are unreliable. They may be attacked on the ground that they are not "representative" since they took place under conditions not likely to repeat themselves, as in the case of a forced sale; or that they were too distant in point of time or of place from the date or place of valuation; or that the sales were of property essentially different from the property in question; or that the sales were not in the quantities that would be involved in a sale of the existing property; or that the sales were in a different market from the one available to the present owner—say, in a wholesale market rather than a retail market.

All of these types of objection are plausible, and their force would be recognized by the appraisal profession. But their application to any given case cannot be determined by formulas, such as a formula that the sale of stock is inadmissible in proof of its value unless it took place within 30 days of valuation date; and the courts have wisely refused to lay down any but the most general rules on these issues. One of the reasons why the courts have declined to announce rigid rules is their recognition that the law, like the appraiser, must get along with the best evidence available; and a very risky inference that property *A* is

worth what property B was just sold for, or that property A is now worth what it sold for 1 year ago, may nevertheless be safer than any alternative inference proposed by the objecting litigant.

In the first section of this chapter we noted that one of the ways by which an appraiser may seek to cure the defects of an inference as to the value of one property based on earlier sales of the same property, or based on recent sales of different property, is to apply some corrective in order to equate the recognized difference. In valuing a corner lot of land, an appraiser would not assume that this value is directly measurable by the sale price of a side lot. But he may, nevertheless, seek a tentative basis of valuation by taking the side-lot price and by adding a premium for corner-lot value. By the same use of correctives, the appraiser may attempt to allow for time differences. This form of inference is of course dangerous, since the relationship between the values of different properties, or between the values of the same property at different times, cannot be measured by reliable formulas. But appraisal is necessarily a dangerous profession, and even greater errors are likely to result from the use of other methods of valuation, such as those based on a capitalization of realized or estimated earnings.

Within limits, the courts have permitted litigant parties to establish the sale prices of similar properties for whatever bearing these prices may have on the value of present property. But in certain fields of law, for example in condemnation cases, some courts have been reluctant to admit such testimony even when an expert appraiser would regard it as relevant and useful for his purposes. Thus in New York and one or two other jurisdictions, evidence of the sale price of neighborhood property has been held inadmissible on direct examination as evidence of the value of the instant property. While not denying the relevance of the evidence, these courts have held that too many collateral issues would be raised as to the degree of similarity between the property that was actually sold and the property that is being valued. We discuss these holdings in our treatise on valuation under the law of eminent domain.[6] In our opinion they are unfortunate, not because they are wholly without merit, but rather because they seem to imply that any other evidence as to the value of real estate can avoid raising a host of collateral issues. Certainly estimates of current replacement cost are subject to at least as much doubt as to their significance.

Sales as Evidence of Value to the Owner.

The use of sales of the same property or of similar properties as an index of value is most clearly appropriate in those cases

[6] Orgel, *Valuation Under the Law of Eminent Domain*, Chap. 12.

where the object of the appraisal is to estimate market value. Indeed, the very fact that a court invokes some other standard, such as value to the owner or so-called "real value," is likely to mean that the property is unique and that no actual sale prices can be established. But even when the nominally accepted basis of valuation is market value, a court may construe this phrase so as to make it indistinguishable from value to the owner. The question may, therefore, be raised whether this latter value may be measured by actual sales.

This point has already been discussed briefly in Chap. IV,[7] where it was noted that the market value of a property may often be taken as the best measure of value to the owner. Under these circumstances, any evidence that tends to show the former value would also tend to show the latter. Moreover, if the actual sale referred to was the sale of the property to its present owner, the fact that the owner voluntarily paid the recorded price for the property is an indication of the minimum amount at which he valued it.

Other concepts of value, like that of value for rate-making purposes, are too complex for treatment in these chapters on the general problems of evidence. The relevance of sales in proof of these "pseudo values" will therefore be left for the special chapters on value for specific legal purposes.

[7] At pp. 91–92.

CHAPTER VIII

ACTUAL OR ORIGINAL COST AS A MEASURE OF VALUE

Few other types of evidence are so generally and so emphatically distinguished by the courts from the values of which they are supposed to be probative, as are statements of actual or original cost. Even estimated replacement cost, although also admitted as mere *evidence*, is not so sharply contrasted with value. When Justice Hughes, speaking for the Supreme Court in a famous public-utility rate case, remarked, "It is that property, and not the cost thereof," which must be protected from confiscation,[1] he was here distinguishing the current value of the property from its original construction cost, rather than from its hypothetical cost of reproduction.

Yet there are many types of valuation where testimony as to the actual cost of the property has had an important influence; and in certain cases this cost seems to have been accepted, with or without slight modifications, as the very measure of value. It is therefore pertinent to inquire why the cost that was originally incurred in the construction of property, or the price that was subsequently paid by a purchaser, should be deemed to have any bearing on present value. Before this problem is raised, however, something must be said as to the ambiguities of the term "actual cost," and as to the question whether this cost can be ascertained with precision or whether it can only be approximated by estimate.

Actual Cost, Original Cost, Historical Cost.

The "actual cost" of any given property refers to the cost actually incurred in its construction or acquisition. The same property may therefore have had more than one actual cost. Thus a ship may have been constructed by a shipbuilder at a cost of $1,000,000, conveyed to a steamship company at a cost of $1,300,000, expropriated, during a war, by the government at a cost of $2,000,000, and subsequently purchased by its present owner, another steamship company, at a cost of $500,000. Each of these four figures is, with equal accuracy, designated the "actual cost" of the ship.

[1] Minnesota Rate Cases, 230 U.S. 352 at 461 (1913).

Appraisers have often used the term "original cost" to refer to the outlay involved in the *construction* of a manufactured or erected property, as distinguished from a subsequent transfer price. Even when thus restricted, however, original cost has sometimes been taken to mean the price for which a newly constructed property is delivered to the person to whose order it is constructed, rather than the outlay incurred by the builder or manufacturer. Moreover, original cost is used, at times, to refer to the acquisition cost incurred by the *present* owner, regardless of the mode of acquisition. In accounting, for example, the traditional rule that fixed assets should be valued at original cost is usually taken to refer to cost to the present company.

In some fields of appraisal, especially in public-utility valuation for rate-making purposes, a third synonym, "historical cost," has gained some currency. Occasionally, this term has been used to denote the original construction cost.[2] But the designation is not apt, since *any* actual cost is a matter of history; and usage is not uniform on this point. In the absence of generally accepted distinctions, we shall use "actual cost," "original cost," and "historical cost" interchangeably, making appropriate explanations whenever the subject so requires.

Is Actual Cost a Question of Precise Fact or an Opinion Estimate?

One of the chief merits claimed for actual cost as a basis of valuation, especially when this cost offers itself as an alternative to hypothetical cost of reproduction, lies in its supposed ease of ascertainment and in its high degree of objectivity. The price that the owner of a given property actually paid for it seems to be a question of fact which can be answered precisely by resort to bookkeeping records, or even by the recollection of the parties who took part in the transaction. On the other hand, the price that would now have to be paid for the replacement or reconstruction of the property is clearly a matter of opinion estimate, which may be subject to a wide margin of error. This reputed practical advantage of actual-cost records explains their acceptance as important, sometimes as exclusive, indices of "present value" even in cases in which the courts have recognized prevailing

[2] At least one public service commission has used "historical cost" in a peculiar sense, as referring to an *estimate* of the original cost of the property now in use, made in lieu of reliable records of actual outlays. The estimate is based on the application of market prices current as of the time of the construction, to the present inventory. Re Boise Water Co., P.U.R. 1926D, 321, cited by Robert H. Whitten and Delos F. Wilcox, *Valuation of Public Service Corporations*, Vol. I (New York, 1928), p. 590.

replacement cost as a theoretically superior measure. It also supplies orthodox accounting with *one* of its major arguments for the balance-sheet valuation of fixed assets at original cost, without revision for subsequent price changes.

Regarded as a matter of degree, the accepted distinction between the speculative character of replacement-cost estimates and the objective character of actual-cost records is quite warranted. But, as all accounting authorities recognize, even original cost, when construed in such a way as to make it serve as a plausible measure of property value, is by no means devoid of the factor of judgment.

We may note, first, that the actual money outlay for which a given property was acquired is often incapable of proof due to the absence of reliable records and memories. This difficulty has constantly arisen in the valuation of railway and public-utility properties constructed or purchased prior to the development of standardized accounting by public service commissions. The Interstate Commerce Commission has confessed its inability to determine the original costs of the major portions of the older railroads, despite the fact that Congress specifically demanded their ascertainment as one of the "elements of value."[3] In real-estate condemnation and tax cases, records of actual purchases have sometimes been quite unavailable, sometimes deliberately falsified by collusion between buyer and seller.

But even when reliable records are at hand, there remains a more fundamental difficulty, in that "original cost" must often be interpreted as a term of art rather than of science in order to make it acceptable as a measure of present value. If one could always define this cost as a sum of money disbursed in exchange for specific property in a bona fide transaction at arm's length, few serious problems of interpretation would arise. Unfortunately, however, a modified construction of the term is often required.

In the first place, one must consider those transfers of property where some non-monetary consideration was paid for the property—instances of barter, including that modern type of corporate barter, the issuance of stock in exchange for property. Here the original cost of the property must be interpreted to mean the value of the property or services given in exchange, as of the date of this exchange.[4] Under these circumstances, "original cost" partakes of the same ambiguities that attach to the word "value."

[3] I. Leo Sharfman, *The Interstate Commerce Commission*, Vol. III A (New York, 1935), pp. 138–150.

[4] For the disposition of this problem in Federal income taxation, see *infra* pp. 992–993.

In the second place, even when the property was acquired entirely for cash, the payments may have been spread over a considerable period of time, with the result that allowance must be made for the interest factor. Were no such allowance made, a property which was bought for $10,000, full cash on delivery, would be recorded as having the same original cost as another property, bought at the same time for the same total price, but under a deferred-payment arrangement. Strictly speaking, the original cost of these two properties would, indeed, be the same, the only difference being in time of outlay rather than in total amount. But a *hypothetical* original cost may be required for the purpose of making the two purchases comparable—say, such an outlay as *would* have been made, had both properties been fully paid for on delivery date. Here, again, the appraiser must resort to judgment setimates.

Finally, we must take cognizance of those properties whose money costs cannot be stated objectively because they were constructed or purchased by a lump-sum payment covering other property not included in the pending appraisal. What was the actual cost of a house purchased along with a piece of land for a total price of $50,000?[5] Or of that portion of a dam which is serviceable for power uses as distinct from navigation uses? The question is unanswerable by reference to any objective tests, and the appraiser is forced to make "fair allocations," most of which are arbitrary. The joint-cost difficulty arises in most extreme form in an attempt to determine the actual manufacturing cost of a particular unit of output of a factory. A great field of accountancy, called "cost accounting," is devoted to the attempt to secure acceptable practical answers to this problem. But even the most refined and modern types of cost accounting involve arbitrary allocations that can be defended only on the ground that no better formulas suggest themselves. We must therefore recognize that a report even of actual cost, and not merely of replacement cost, may involve judgment estimates subject to wide differences of opinion or of accounting convention.[6]

[5] Questions of this nature have arisen under the income-tax laws. See *infra* pp. 990–992.

[6] The necessity of resort to judgment becomes all the greater when the original-cost standard is modified by allowance for depreciation, or by a rule that only the *legitimate* cost or "*prudent* investment" shall be included. The annual reports of the Federal Power Commission reveal many wide discrepancies between the claims of the companies and the findings of the commission as to the "actual legitimate costs" of hydroelectric projects. The Clarion River Power Company is said to have claimed that its project actually cost $11,000,000, whereas the commission's chief accountant reported a "legitimate" cost of only $4,500,000.

Bearing of Actual Cost on Present Value.

In these days, when millions of investors in securities, in real estate, and in commodities find that the present market values of their properties are but a mere fraction of the prices which they paid for them before the business depression, one need hardly point out that there may be a world of difference between the original cost of property and its current value. The question arises, then, why this cost is even relevant as *evidence* of value. The relevance may be due to any of several reasons which will be noted in turn.

In the first place, the price which the present owner has paid for the property represents one actual sale of that property and therefore deserves the same consideration that might be given to *any* sale made at that time. When considered in this light, testimony of the price paid by the present owner deserves no more weight than would testimony as to equally recent sales of substantially identical property. It is to be considered simply as one of the many transactions which give ground for an inference as to the range of prices within which property of the type in question has recently been selling. A court will quite properly exclude or ignore testimony as to actual cost when the property was acquired at such an early date or under such peculiar conditions that the transaction gives no proper basis for an inference as to present value.

The second reason why testimony as to actual cost may properly be admitted is that this cost may be the best available measure of current reproduction cost. In the valuation of a new house, for example, actual construction cost may be better evidence of its current reproduction cost than would the opinion testimony of an appraisal expert. Even if construction costs have changed between the date of construction and the date of valuation, the original cost may nevertheless be used as a starting point for the estimate of probable cost of reconstruction. Appraisers have at their command index numbers showing yearly changes in the costs of constructing various types of buildings, and these index numbers may be applied to the original cost as a means of deriving the estimated current costs.[7] The application of index numbers cannot be expected to yield accurate results. But unless the change in prices has been very great, the result may be quite as accurate as would a *superficial* reappraisal of the property without reference to its original cost.

In many of the petty valuation cases that arise under the law of damages, the actual price paid by the owner of the property has been

[7] See *infra* pp. 166–167.

accepted as the measure of its value, with allowances, where necessary, for depreciation. This has been done, for example, in cases involving the valuation of secondhand clothing, where the courts have held that the price at which the clothing could have been sold in the secondhand market should not determine the owner's recovery. In most of these cases, a court would recognize the current replacement cost of the property as a theoretically superior measure of its current value. But the pettiness of the claim and the assumed similarity between actual cost and replacement cost have often led to the acceptance of the former figure as measuring the award. When actual cost is admitted in proof of replacement cost, and therefore only indirectly in proof of value, it is of course subject to the same defects to which replacement cost itself would be subject as evidence of value. We discuss this point in the following chapter.

A third possible reason why actual cost may suggest itself as a measure of value applies only to a situation where value to the owner, rather than market value, is the desideratum. Let us assume the problem of finding the value to the owner of a peculiarly constructed property which would command only a very low price in the market—for example, an extravagant and somewhat fantastic residence of a type which would not appeal to wealthy purchasers of ordinary taste. If the owner of this property has recently constructed it at a cost of, say, \$100,000, or if he has recently bought it at this price from some other owner, the fact that he was willing to pay so large an amount for it is some evidence of its probable value in his eyes. Of course, the owner's own valuation may have changed since the time when he acquired the property, and this likelihood may become almost a certainty if the owner has subsequently moved out of it or offered it for sale. Nevertheless, any estimate of the value of peculiar property to its owner must necessarily be based on the merest surmise. In default of other evidence, an appraiser or court may therefore be justified in assuming that the property is now worth to the owner the price which he recently paid for it. This assumption is not necessarily belied by the fact that the current reproduction cost of the property is far greater than the owner's actual cost. As will be noted in the following chapter, reproduction cost is good evidence of value only when one may assume that the present or prospective owner of the property would wish to reproduce it at current prices in case he were to be deprived of it. There is no good reason, however, to assume that a person who has paid \$100,000 for a peculiar house or building would now be willing to pay \$200,000 for that same building simply because this higher price represents its current reproduction cost.

Finally, we may mention a fourth reason why an appraiser may take cognizance of actual cost as bearing on present value—one which is applicable only to public utilities and railways. The value of a utility property is dependent on anticipated earnings. But the earnings themselves may be limited by regulation to a "reasonable rate of return" on what the courts have unhappily called "the fair value" of the property. Actual cost is a legally accepted factor in the determination of "fair value" and may therefore have a bearing on the commercial value of the property, through its influence on rates and thereby on earnings. The point is again touched upon in Chap. XII, on the valuation of an enterprise.

Actual Cost Sometimes Influences the Valuation beyond Its Merits as Probative of Present Value.

Despite the four above-stated reasons why the actual cost of property may sometimes be taken as indicative of its present value, one must recognize that the cases in which any one of these reasons justifies the inference that actual cost and present value are approximately equal are very limited. In all but a small minority of important valuations, the lapse of time between the actual purchase of the property and the date of its valuation will have created a wide gap between the two figures. For example, the actual construction cost of a street-railway system which was built prior to the World War is of so little significance today, as indicating the value of that system to investors in its securities or to prospective purchasers of the entire enterprise, that it would be completely ignored in a business transaction involving the sale of securities or the exchange of the underlying property.

What we now have to note is the fact that the courts often accept actual or original cost in proof of value, despite the fact that a hard-headed businessman, in deciding upon the price for which he would either buy or sell the property, would hardly turn his finger to discover the amount of this cost. Not only is the testimony admitted, but it is sometimes given important, or even dominant, weight.

The most outstanding examples of this situation are to be found in the fields of public-utility rate making and of asset valuation for purposes of measuring net income. In these instances actual cost is a better basis of "valuation" than value itself would be.[8] But since the courts adhere to the doctrine that "value" is the thing to be found, they partly correct this misstatement of the legal rule by giving much weight

[8] See Chap. XXX.

to actual cost, despite cogent evidence that the cost of the property does not even approximately measure its present value.

In other types of valuation, such as those presented under the laws of damages, of eminent domain, and of property taxation, the courts take their distinction between cost and value much more seriously; and in these fields most of the rulings as to admission or exclusion of testimony on actual cost may be accounted for on the hypothesis that testimony is to be admitted only in so far as it will aid the tribunal in estimating value. Where testimony of actual cost is presented, however, there is ground for suspicion that a jury—and even a court itself—is often led to make the award at least equal to this cost even though an appraisal expert would give it little weight in arriving at present value.

An illustration of the popular tendency to associate the value of a property with its actual cost has been furnished the author by a colleague who owns a house in New York City. This house was built by its present owner at a time when construction costs were very high. Not far away stands another house, of similar size and construction, built a few years previously when construction costs were much lower. Finding that his house was assessed by the New York tax assessor at a much higher figure than the neighboring house, the owner asked if his assessment might not be reduced so as to approximate the assessment of the latter. The assessor declined this request. He did not deny that the two houses were approximately equal in their good qualities, nor that their costs of reconstruction were about the same. But he insisted that the higher original cost of the former house should be given weight, "since any economist knows that cost is an element of value."

It is not merely tax assessors and juries whose valuations are influenced by actual costs to a greater degree than an expert appraiser would deem justified. Even businessmen are reluctant to act on the assumption that the property which they have bought is worth less than what they have paid for it.[9] One of the principles of sound invest-

[9] A German financial authority, Schmalenbach, referring to the tendency of businessmen to evaluate their property by reference to its actual cost, which he calls the "false standard of the past," credits the Americans with the greatest success in avoiding this backward-looking standard and charges his fellow countrymen with being least successful. E. Schmalenbach, *Finanzierungen* (3d ed., Leipzig, 1922), pp. 4–6. But American businessmen are by no means free from a tendency to associate the "real value" of their property with the price that they happen to have paid for it. Note, for example, the address of the chairman of the Commonwealth Edison Company at the annual stockholders' meeting on Feb. 28, 1933, justifying the decision of the directors to carry certain investments in other utility companies at their original purchase price, for balance-sheet purposes, despite the subsequent drastic fall in market prices. The chairman is quoted as

ment is that, barring the effect on his income tax, an investor should take no account of the price which he has paid for his security in deciding whether or not to sell it at current prices. But the test is one which few investors actually succeed in passing. The reluctance to "take a loss," as long as one can hope to avoid it, is a powerful deterrent to action.

Even in large business transactions, such as those which take place when property or securities are exchanged in a merger or consolidation, the promoters of the transaction must take account of popular reluctance to sell or exchange property on terms which result in the "taking of a loss." In an agreement to exchange two security issues, one might suppose that the terms of the exchange would be based entirely on the relative present values of the two securities. Yet, even though the exchange may fairly be supposed to result in advantage to both parties, the promoter may find very hard sledding in convincing either party to make the trade unless some account is taken of the relative prices which the two parties actually paid for their issues. Financiers regard such considerations as "irrational," since they are not based on the future prospects of the two properties but rather on their past histories. But the unbusinesslike motives must nevertheless be respected.

In so far as the price which an owner has paid for his property actually affects his attitude toward that property, however irrationally, it

saying: "The situation of the company in this regard is the same as that in which those of you who own homes find yourselves. The fact that at the present time there is absolutely no market for such a home does not lead you to believe that it is worthless, or worth only half its cost, merely because you cannot sell it, *when it is worth its full cost to you and your family as a home.*" This last statement, which we have italicized, contains an implied fallacy that appraisal experts have a hard time in uprooting: the fallacy of assuming that (*a*) because a given property was worth what it cost when it was bought, and (*b*) because it is now just as useful to its owner as it was at that time, therefore it is now worth its purchase price. The fallacy lies in the assumption that, as long as the usefulness of a commodity does not change, its monetary value remains unchanged. Writers in accounting have not infrequently committed this fallacy in justifying the practice of valuing fixed assets at original cost (minus a reserve for depreciation) despite subsequent changes in replacement costs. See, for example, Prosper Reiter, *Profits, Dividends and the Law* (New York. 1926), p. 242: "Moreover, so long as an asset is being used as a going concern, its value to the business doesn't change." In fact, the best defense of the rule of balance-sheet valuation at actual cost is, not that this cost measures present value, but that it constitutes a desirable book-keeping record in its own right. But the traditional assumption that a balance sheet is supposed to measure the value of a company's assets dies hard, although it has been sharply attacked by George O. May and other modern accounting experts. On this point see *infra* pp. 902–906; Chap. XXVII; pp. 1194–1195.

does in fact influence value in one sense of the word. If we mean by "value," value to the owner in the sense of the importance which the owner himself attaches to his property, we must recognize every factor affecting that subjective valuation which has a material influence on the owner himself. The price actually paid for the property may therefore be taken into account as one form of sentimental value. Courts, however, do not construe value to the owner in this sense. They refer to the value which a *reasonable* owner would attach to the property. Whether or not they would regard the psychological influence of actual cost on the owner's valuation as something which would be taken into account by a "reasonable man" is a question which we have never seen discussed in the cases.

It is impossible for the reader of the reported opinions to gauge the extent to which tribunals are influenced by their notions of fairness rather than by notions of strictly evidentiary relevance when they accept actual cost as good evidence of "present value." Reported opinions are confined, for the most part, to those of appellate courts; and these courts seldom discuss the weight given to the evidence as distinct from the question whether or not the evidence was admissible. On the whole, it is apparent that any "undue" influence of actual cost, from the point of view of the assumed premise that the present value of the property is the thing to be found, is an influence which takes place in spite of the principles of valuation officially approved by the higher courts. The legal doctrine in the valuation of property is quite in line with the economist's distinction between cost and value, and most of the rulings of the courts as to admissibility of testimony on actual cost can fairly be reconciled with this doctrine.[10] To the extent that a jury or a court may disregard this legal tradition, it is introducing an element of "lawlessness" into the award. Some persons would say, "a *proper* element of lawlessness," because they believe that the impulse of the tribunal to break down the distinction between cost and value results in greater justice than would result from a strict adherence to this distinction.

[10] But in a recent condemnation case, the New York Court of Appeals seems tacitly to have accepted the original price paid by the owner for easements of air, light, and access, as a just measure of compensation in its own right, and not merely as evidence of "present value." Matter of City of New York (Manhattan Ry. Co.), 265 N.Y. 170, 192 N.E. 188 (1934), discussed *infra* pp. 427–429.

CHAPTER IX

REPLACEMENT COST AS A MEASURE OF VALUE

Perhaps the most strikingly distinctive feature of *judicial* valuation, in this country at least, is to be found in the proneness of the courts to single out the estimated replacement cost of replaceable property, minus certain allowances for depreciation, as the most reliable index or measure of value. This tendency, to be sure, is seldom carried to the extreme of a complete identification of the measure of value with the value itself. Nearly always in theory and often in practice, replacement cost has been recognized as mere *evidence* of value—fallible evidence at that. One can even find cases in which testimony as to cost of replacement, if not held formally inadmissible, has at least been practically ignored in favor of valuations based on capitalized earnings or on other data. But a litigant who wishes to belittle the significance of replacement-cost estimates will usually find more difficulty in persuading a judge than in persuading a modern appraisal expert or accountant.

Outside of the field of public-utility valuation for rate-making purposes, where the only plausible defense of replacement cost is that it constitutes a desirable rate base in its own right, quite without reference to value in any accurate sense, the sharpest disputes as to the relevance of this type of evidence arise with respect to business properties that are yielding disappointing income. In these instances, counsel for the party desiring the high valuation is sure to insist that "great weight" be attached to what he will probably call "physical value"; whereas counsel for the party desiring the low valuation will be likely to deny that replacement cost has anything to do with value and will probably claim that the appraisal should be based exclusively on capitalized income.

On an issue of this nature, the courts have sometimes gone the one way, sometimes the other way. Often, however, they have compromised by stating that replacement cost and capitalized earnings should both be "considered." Their theories as to the simultaneous relevance of the two conflicting data are not often clearly stated. At times they seem to be confusing the very concept of value with the concept of replacement cost. At other times they have in mind the

likelihood that the earning power of the property is merely temporarily depressed and that it may soon rise to the point of a normal rate of return on replacement cost. This seems to have been the view of the late Chief Justice Taft, who participated as an arbitrator in the valuation of the stock equity of the Grand Trunk Railway, which was taken over by the Canadian government.[1] The other two arbitrators found that there was no equity whatever, since in their opinion the prospective earnings per share were a minus quantity. But Mr. Taft dissented, on the ground that some consideration should have been accorded to the cost of reproducing the railway system.

It is doubtless true, as Mr. George O. May testified in the litigation of the proposed Bethlehem-Youngstown steel company merger,[2] that modern financial practice and appraisal theory accord much less significance than formerly to "physical valuations" and much more significance to reported and estimated earnings. But it would be utterly disastrous to ignore replacement costs; for they have a significance, not possessed by any other data, in setting (with qualification discussed later) the *upper limit* beyond which a replaceable property may not fairly be valued. Mr. May recognized this point when he testified that an industrial plant "can't be worth more than it would cost to reproduce it; neither can it be worth less than salvage value if it were destroyed." Indeed, there is much evidence that, within the last few years, professional appraisers and security analysts have gone much too far in belittling the importance of replacement-cost data. Their very proper reactions against the popular assumption that property is normally worth its replacement cost, minus conventional deductions for depreciation, has led some of them to the equally untenable position that replacement cost can safely be ignored.

[1] See Leslie T. Fournier, *Railway Nationalization in Canada* (Toronto, 1935), Chap. 7. The Privy Council, in England, upheld the majority of the arbitrators in ruling that the estimated replacement cost of the railway property was inadmissible in proof of the value (or lack of value) of the stock equity. Grand Trunk Ry. v. The King, [1923] A. C. 150. In his dissenting report, Mr. Taft made the point that the earning power of the Grand Trunk was dependent on the rates which it might charge for traffic, and that these rates were dependent on rates fixed on United States trunk lines, which in turn were dependent on "physical values" under the doctrines of rate making established by the United States Supreme Court and embodied in the Transportation Act of 1920. Indeed, about one-third of the Grand Trunk Railway system was located in the United States.

[2] Wick v. Youngstown Sheet & Tube Co., Court of Common Pleas of Mahoning County, Ohio, unreported, Record, Vol. XV, pp. 5008–5016. Compare Frederick M. Babcock, *The Valuation of Real Estate* (New York, 1932), p. 36: "There is rarely, in fact, any connection between the cost of replacement of a building and its value."

DEFINITIONS OF REPLACEMENT COST AND REPRODUCTION COST

In its most useful sense, the replacement cost of property means the cost that would be incurred by an actual or potential owner in acquiring an acceptable substitute property. But this is a broad definition, since it does not predetermine either the type of the substitute or the mode of its acquisition. It therefore fails to preclude very different findings as to the replacement cost of the same property at the same time.

Among the almost numberless distinctions that can be made, the following are the most important. Having reference to the *type* of the substitute property, one may distinguish between the cost of acquiring (*a*) a new, but otherwise substantially identical, replica, (*b*) an equally depreciated substitute, and (*c*) the most advantageous new and modern substitute. These alternatives may be termed, briefly but inaccurately, identical-replacement cost, secondhand-replacement cost, and best-substitute-replacement cost.

Having in mind the *mode* of acquisition, one may also distinguish between the cost of purchasing an already available substitute and the cost of having the substitute constructed or manufactured to order. The first cost may be termed "market-replacement cost," while the second is often referred to as "reproduction cost." But the latter term is sometimes restricted to the cost of constructing a substantially *identical* new property, thus combining the second alternative mode of acquisition with the first alternative type of substitute.

We shall later note that the proper choice between these various replacement costs depends on the theory of relevance on which the appraiser relies for his assumption that the value of any property is affected by cost of replacement. Under the "competitive-price theory," only the cost of constructing or manufacturing the best available substitute property is relevant; whereas, under the "law-of-substitution theory," a market replacement should be assumed if it would constitute the owner's best available option. Oddly enough, the courts have tended to single out the one concept of replacement cost—cost of constructing a substantial replica—which has no direct bearing on value.[3] They have only partly offset this fallacy in their allowance for obsolescence.

In public-utility valuation for rate-making purposes, replacement cost is sometimes given "cruel and unusual" interpretations of no pertinence to a commercial appraisal and of doubtful pertinence even to rate control.[4] Thus, the courts have often taken as a measure of

[3] See *infra* pp. 164–165.
[4] See Bauer and Gold, *Public Utility Valuation* (New York, 1934), Chap. 7.

"fair value" the present cost of reconstructing the property under physiographic conditions prevailing at the time of the actual, original construction—"historical reproduction cost." No advocate of this hybrid basis of valuation has ever supplied a plausible argument as to its cogency. Again, land has occasionally been valued at the estimated cost of reacquiring the very same site, instead of at the estimated cost of the best available, alternative site. This practice is indefensible; indeed, the Supreme Court has apparently rejected it in favor of the no less arbitrary, though more practical, rule that land shall be assigned an "imputed market value" based on the current market prices of adjacent land. But the whole underlying philosophy of rate control by valuation is so absurd that its absurdities are hardly enhanced by these detailed inconsistencies.

THE THEORY OF REPLACEMENT-COST VALUATIONS

Even the most outspoken critic of so-called "replacement-cost" valuations would hardly contend that this type of cost has no bearing whatever on value. It is important, therefore, to consider the basis for the universally conceded relationship between the value of a given property and the cost of a substitute property. Only by a close analysis of this elementary problem can we reach an intelligent conclusion as to whether and when an appraiser is justified in estimating the replacement cost of a property as a first step, at least, in arriving at its value.

Here, as elsewhere, we must premise this discussion of the "theory of relevance" by noting the necessity for a prior agreement as to what is meant by the "value" of which replacement cost is assumed to be evidentiary. In this chapter we shall assume, unless otherwise stated, that the appraisal is designed to disclose either (*a*) market value, defined as the price at which the owner of the property could actually sell it to someone else, or (*b*) value to the owner, defined as the payment that would indemnify the owner for the loss of his property. Even this dual assumption is somewhat confusing; but the confusion need not be serious, since the determination of market value has many things in common with the determination of value to the owner or "to the going concern."

First Theory of Relevance: Law of Competitive Price.

The literature of appraisal discloses two very different theories of relevance under which the estimated replacement cost of a given property may furnish a basis for an inference as to its value. These theories may be designated "the law of competitive price" (or "normal value"), and "the law of substitution." In practical appraisal the

former is far less significant than the latter. Yet many writers have given it exclusive attention in their formal exposition.

The competitive-price theory has been taken over by appraisers[5] from the "classical school" of economics.[6] It asserts that, under conditions of "perfect competition," the market prices or market values of any given commodity tend, "in the long run," to equal cost of production. Production cost is here taken to include expenses of marketing no less than of manufacture, and also to include a "normal" interest on the investment and (according to some economists) a normal profit to the entrepreneur.

This tendency of market prices to align themselves with production costs is attributed to the forces of competition under which the supply of the given type of commodity will adjust itself to the demand. If the market price of wheat, or of cotton cloth, falls to less than cost, farmers and manufacturers will reduce their output until equilibrium is restored. On the other hand, if the price exceeds cost, the opportunity to make abnormal returns will stimulate producers to increase their output, until the equilibrium price is again reached. The adjustment, to be sure, may take months or even years; and before it is made, it may again be upset by a new disturbance either on the demand side or on the supply side. But the tendency is constantly operative under competition, just as is the tendency of the surface of an ocean to reach a level.

Assuming the validity of this theory of competitive price or "normal value," how might an appraiser make use of it? The answer is that, if he has no more reliable basis on which to estimate present value, his most plausible assumption is that the property is in fact now worth its *normal* value. Of course his assumption may be wildly wrong; for even the staunchest supporter of orthodox economics would concede wide discrepancies between what a particular commodity is now worth, and what it would be worth if the "law of competitive price" were alone operative. Even so, the resulting valuation may have a greater claim to acceptance than one determined, say, by tossing a coin or by counting the steps of the Eiffel Tower.

We have spoken so far about cost of *production*. Does this refer to the cost actually incurred by the producer of the very object of wealth whose value is in dispute, or to the cost that must be incurred in

[5] See, for example, Walter W. Pollock and Karl W. H. Scholtz, *The Science and Practice of Urban Land Valuation* (Philadelphia, 1926), p. 16.

[6] Practically all textbooks on economic theory present the classical theory of competitive prices, sometimes with approval, sometimes with dissent. Alfred Marshall's *Principles of Economics* (8th ed., London, 1920) remains the standard reference on the theory in its modern dress.

producing a substitute? The early economists seem not to have considered this question, and even most of the recent writers have not raised the issue in so many words. But Alfred Marshall[7] notes that the point was raised by H. C. Carey, who insisted that the relevant cost is cost of reproduction rather than original cost. The force which is supposed to bring prices into accord with manufacturing cost through its influence on output is the contemplated cost of producing more units of the same type of commodity, not the historical cost incurred in the production of those commodities which have already been created. In a somewhat cryptic passage, Marshall states that, when used in the theory of market-price fixation, cost of production and cost of reproduction have the same meaning. For even the first term refers, not to the peculiar cost of producing any particular unit, but rather to the *normal* cost of producing units of the same type of commodity. It is the "representative" cost of producing wheat of a given grade, not the cost of producing this particular bushel of wheat in my possession, which determines the normal market price of wheat.

An adequate treatment of the relationship between production cost and value, as envisaged by modern economists, would require a large book, which only a specialist would be competent to write. Among other things, such a study would have to attack the problem of determining the relevant cost when (as is usually the case in competitive industry) these costs vary widely, not only as between different producers, but as between different units of output by the same producer. It would also have to consider how long is a "long run," and what kind and degree of competition is required in order that the law of "normal value" may be deemed effective.

In a treatise on appraisal, however, no such study is necessary. For all modern economists, even those who remain loyal to the orthodox theories of price determination, agree that production costs are very unreliable measures of value. Marshall's statement that "cost of reproduction exerts little direct influence on value, save when purchasers can conveniently wait for the production of new supplies," would be generally accepted in the profession.

Among modern appraisers, the theory of competitive prices is seldom adduced in justification of a valuation based on reproduction cost. Yet it is frequently invoked in favor of an appraisal which takes some indirect amount of the reproduction cost of property as bearing on the income which the property may be expected to yield in the future. Business enterprises, for example, are usually valued by a capitalization of their reported or estimated earning power. But

[7] *Op. cit.*, pp. 401, 634.

earnings which are deemed to exceed a normal rate of return on the replacement costs of the physical assets are sometimes capitalized at a high rate, on the theory that competition may soon force the enterprise to be content with a mere "reasonable return."[8] Similarly in real-estate appraisal, the unusually high rentals which properties may command during a boom period, or the unusually low rentals received during a depression, may be belittled on the ground that they reflect a market condition which cannot long persist. These mild concessions to the reproduction-cost theory of valuation are a far cry from the naïve assumption that, because the property in question would cost so much to reconstruct, therefore it must be worth about this amount.

As developed by the classical economists, the theory that market prices tend to approximate production costs is applicable only under conditions of competition. This restriction would outlaw the theory as a basis for an inference that the value of monopolized property approximates its reproduction cost. Most public-utility and railway properties come in this category, in that the free play of competition cannot be assumed, even "in the long run," to bring their commercial values into close conformity with their reconstruction costs. But when their rates of charge are regulated by government, and when the government itself attempts to determine these rates by reference to a reasonable return on prevailing replacement costs, these costs may properly be considered by an appraiser as having a bearing on future earnings, and hence on the present commercial value of the enterprise. More will be said on this point in Chap. XII, on the valuation of a business enterprise.

Second Theory of Relevance: The Law of Substitution.

We have already stated that the theory of competitive prices or "law of normal value" constitutes the least persuasive basis for the assumption of a relationship between replacement cost and value. A far more direct and impelling relationship is to be found in the principle of substitution. When property is replaceable, its owner has the option of replacing it with an effective substitute in case he is deprived of its use. This option limits the value of the property to the owner, since it permits him to mitigate the damages that he would otherwise sustain as a result of its loss. Having a house to live in may be so important to me that I would give my entire fortune rather than go without it. But having this particular house is much less important, since I could buy another, equally attractive house, say, for $10,000.

[8] See *infra* pp. 242–243.

Recognition of this principle of substitution has led appraisal writers to lay down the rule that the replacement cost of property ordinarily sets the approximate *upper limit* of its value.[9] The rule is applicable, not only when value to the owner is in question, but also when market value is desired. A prospective purchaser will not rationally pay $15,000 for a house, or for 100 shares of stock, or for a shipment of wheat if, without serious delay, he can build or buy equally satisfactory substitutes for $10,000.

It is this principle of substitution, and not the economists' law of normal value, which has led the courts so generally to accept replacement cost as a measure of recoverable damages. The plaintiff is presumed to be "made whole" if he is given enough money to reimburse him for the expenditure to which he would have been put, had he decided to replace the property.

The "Incidental-damage" Factor.

The maxim that the replacement cost of property sets the approximate upper limit of its value is the most useful rule of thumb in the entire field of appraisal. Were it not for its implications, a single lead pencil or safety pin might be valued at $10,000, and a shanty might be appraised at the price of a palace. Yet it is not invariably valid, and its universal acceptance would sometimes result in a gross undervaluation. Owners and prospective buyers of property cannot secure substitutes instantaneously; sometimes the delay is serious, not to say fatal. In consequence, property which is now available may be worth much more than the cost of a substitute which would be quite as satisfactory save for the fact that it cannot be secured until a future date.[10]

[9] "The fact that in most kinds of real estate the values at a given time cannot greatly exceed replacement cost in no way modifies the general statement that cost and value are distinct and that the cost method of valuation is unsound." Fredrick M. Babcock, *The Valuation of Real Estate*, p. 40. "Normally [fair market value] would be limited by the cost of replacement (summation method so-called), or the expected net income capitalized—whichever is the lower." K. Lee Hyder, "Fractional and Summation Appraisals," 1 *Jour. Am. Inst. Real Estate Appraisers* 7 at 8 (1932). "Generally speaking this cost [reproduction cost] represents the maximum value attributable to a building." Harry G. Baldwin, "Comparative Methods in Establishing the Value of a Building," American Appraisal Company, *Bull.*, 1928. John E. Burton refers to the critical fallacy of the popular assumption, indulged in prior to the business depression of 1929, "that a million-dollar parcel of land plus a building costing a million dollars to build would *have* to be worth two million dollars." *Foreclosure of Property in Manhattan* (Institute for Economic Research, New York, 1934).

[10] John B. Canning is one of the few writers fully to recognize the importance of the incidental-loss factor in appraisal and accounting theory. *The Economics*

This situation frequently presents itself under the law of damages, as where a haberdasher has been tortiously deprived of his supply of straw hats, irreplaceable until the end of the summer; or as where a building contractor fails to receive a shipment of cement, replaceable only after a delay that will impose upon him a penalty for noncompletion of the building. It also arises in the condemnation of real estate during boom times. If the property is replaceable only by construction, and not merely by a market purchase of similar property, the delay may deprive the owner of the temporary opportunity to exact "abnormal" rents, not to mention the opportunity to sell in a crazily favorable market.

In extreme cases, the time factor is so important that, were the present or prospective owner to be deprived of the property, he would not find it worth while to secure a substitute. In such cases, replacement cost should be completely ignored by the appraiser, and the property must be valued as if it were unique—say by a capitalization of anticipated annual income. The courts have sometimes recognized this point, especially in damage cases, by holding that property which cannot be replaced save after fatal delay is, in effect, irreplaceable.

But in less extreme cases, substitution may greatly mitigate the loss, although it may not save the owner or prospective buyer of the property from serious incidental injuries. Here it is often possible for an appraiser to set the *maximum* value of the property by adding to its replacement cost some special premium for immediate availability. Thus a house might be found to be worth not in excess of $11,000 because (*a*) it could be replaced in one year for $10,000, and because (*b*) the adverse value of the year's delay is estimated at $1,000. However, the practical difficulties of estimating in monetary terms those losses which would result from the delay are likely to be so serious that an appraiser or a court will not attempt it. In this event, the only alternatives are either to value the property quite without reference to replacement cost, or else arbitrarily to limit the valuation to replacement cost, on the ground that any excess value is unmeasurable. Both alternatives have been resorted to in litigated cases, the most conspicuous instance of the latter being in the field of fire insurance, where statute law has expressly stated that the insured structures may not be valued at more than replacement cost.[11] Even the common law tends

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of Accountancy (New York, 1929), Chap. 12, especially p. 244. Canning rightly states that the only *invariable* upper limit of value is the present adverse value of the prospective costs of replacing the entire flow of services derivable from the property in question: pp. 243 *ff.*

[11] See Chap. XV.

to place somewhat the same limitations on the appraisal, through its vaguely defined restrictions against allowances for consequential or speculative damages, speculative values, and lost opportunities to make a profit.[12]

When Is Replacement Cost an Acceptable Measure of Value, Not Merely an Upper Limit?

The principle of substitution merely justifies the inference that, aside from the incidental-loss factor, property cannot be worth *more* than its replacement cost. It by no means warrants the further inference that the value is as high as this, or even that the value is nearer to replacement cost than it is to zero. The recent literature on appraisal theory is stressing this point as never before; and the warning is timely because the American courts have often failed to recognize it.

Nevertheless, under certain circumstances an appraiser is warranted in accepting an estimate of the replacement cost of property, with proper allowance for incidental loss and for depreciation, as the best available measure of its value. These circumstances may arise when the appraiser is justified in concluding that, were the property in question to be destroyed or lost, an owner would rationally replace it. Sometimes this conclusion is obviously called for, without reference to any elaborate calculations of the loss that would accrue to the owner of property were he unable to make replacement. Thus, the value of 1 mile of track on the main line of the Pennsylvania Railroad can safely be assumed to be measured by replacement cost (minus allowances for depreciation and plus allowances for delayed reconstruction); for the absence of this part of the organic whole would cripple the earning power of the entire system. By a similar process of inference, one may conclude with only a slight danger of error that a pair of spectacles or a wooden leg is worth its replacement cost to the owner.

But in those valuations which give most difficulty to an appraiser, it is by no means clear that the owner of the property would wisely replace it, were it to be destroyed or lost. Often quite the contrary conclusion is obviously called for, as in the case of most street railways and of many steam railroads today. Often the question is not easily answered, as may be the case in the appraisal of an office building or apartment-house property which is now yielding a poor income but which may possibly yield splendid returns in the near future.

When the property is clearly not worth replacing, the appraiser should utterly ignore its replacement cost and attempt more directly to estimate value by capitalizing anticipated income, or else by accepting

[12] See Chap. XIII.

the current market prices of substantially similar properties—prices which in turn are based indirectly on a capitalization of income. But when the wisdom of the replacement is in doubt, the appraiser must make two tentative valuations, the first being based on depreciated replacement cost, and the second probably being based on capitalized anticipated income. The *lower* of these two figures will give him the best available estimate of the value of the property. Thus, if a hotel property could be replaced (without serious delay) for $1,000,000 but if its probable earning power would make it an intelligent "buy" only at $500,000, the appraiser would properly conclude that $500,000 measures its value and would outlaw the replacement-cost estimate. But if his estimate of earnings would seem to justify a valuation of $1,500,000, although the hotel could be replaced without serious delay, by the purchase or erection of an equally profitable hotel, for $1,000,000, he is warranted in disregarding his estimate of excess earnings and in appraising the property at replacement cost. An investor would not be well advised to pay more for the present hotel than the price at which he could acquire the equally attractive alternative property.

The hotel illustration, however, reveals one obstacle to the practical use of the replacement-cost test of maximum value. When we say that the hotel could be replaced for $1,000,000, we ordinarily mean that a substantially similar structure, located on an equally appropriate site, could be bought or erected for this sum. But a hotel with established patronage may possess a good will, only part of which could be preserved on relocation. To some of the old patrons the new property will be less attractive than the old one, and this fact may occasionally be of sufficient importance to demand recognition by the appraiser.

In the appraisal of entire business enterprises or of stockholdings in these enterprises, values materially in excess of the replacement costs of the physical assets are frequently recognized. This recognition, however, does not necessarily derogate from the rule that a property is not worth more than its replacement cost. It may be accounted for on the ground that the replaceable physical assets do not constitute the entire property in question. Courts and appraisers have this point in mind when they make special allowance for "good will" or for "going-concern" value.

Depreciation as a Deduction from Replacement Cost New.

If the loss (or non-acquisition) of the present property would warrant its owner (or its prospective buyer) in acquiring a virtual replica, the property may then properly be valued at the cost of this replica

plus an allowance for the incidental loss that would be occasioned by the delayed replacement. In less cumbersome language, present value is then equal to replacement cost plus incidental damages. But in most disputed appraisals, the owner of the property would rationally replace it, not with an exact duplicate, but rather with a new and otherwise different substitute, which would be either more or less satisfactory than his present property. The chances are strong, for example, that the owner of an old homestead or of an old steam engine would be unable to acquire another property just as good as, but no better than, the one that he now owns. Moreover, even if, by rare coincidence, he were able to find the identic twin, the probabilities are all against his wanting to acquire it. His best available option will be to secure a newer, or more modern, or more adaptable, substitute.

Under these circumstances, replacement cost (with or without an allowance for incidental losses) cannot be accepted without revision as a measure of value. A further allowance must be made for the inferiority or superiority of the present property to the substitute property. In most appraisals, the property in question, being old and obsolescent, would be inferior to the new substitute, and the adverse value of this inferiority must be deducted from replacement cost new. This deduction is generally, though inaccurately, called "depreciation." But the calculation of depreciation presents a baffling problem of appraisal technique, and its discussion is deferred to the next chapter.

The Interest Factor in Appraisals Based on Replacement Cost.

Were it not for the interest or "time-discount" factor, our analysis would now lead to the conclusion that the present value of any property that is worth replacing may be measured by (*a*) the cost of acquiring the most economically desirable substitute property, plus (*b*) the total incidental damages involved in the reacquisition, minus (*c*) an allowance for depreciation. But such a conclusion would ignore a factor that has yet been mentioned only in passing—the time-discount factor. If an owner were now to lose his property, and if he were unable to make practically immediate replacement, his outlays for the acquisition of a substitute, together with his realization of his "incidental losses," might be postponed for a considerable period of time. If he must build another factory, to be completed within 2 years, he may pay for it in installments beginning on the date when he signs the contract and ending on the date of completion. Moreover, his losses of "use and occupancy" may also be strung along during the intervening period and even for a short time thereafter.

If appraisal were as scientific a procedure as it can be made to appear on paper, these time-discount factors would require specific allowance. Not only the prospective replacement outlays but also the prospective incidental damages would be discounted to their present adverse values. The so-called replacement-cost method of valuation would then be seen to be merely a reverse form of the capitalized-income method, discussed in later chapters. It would differ from the latter method only in arriving at the value of the property by capitalizing the outlays which loss of possession would entail rather than by capitalizing the intakes which possession confers.

At best, however, appraisal is subject to extremely wide margins of error. Appraisers therefore seldom attempt nice adjustments for all interest factors. Indeed, when the substitute property can be bought on the open market or quickly manufactured to order, no allowance whatever is usually made for time discount.

What is especially striking, however, is the fact that in large appraisals based on the estimated reproduction costs of plants that require a year or more for completion, most appraisers allow for the interest factor in a way that would seem directly *opposed* to the one just suggested. Instead of *discounting* the prospective construction outlays, they *add* an allowance for interest during construction, sufficient to compensate the owner for funds advanced prior to the date as of which he may enter and operate the plant.

In short, the conventional reproduction-cost appraisal involves an assumption materially different from that which we have here posited as the background for our theory of relevance. Instead of assuming, as we do, that plans for replacement will commence only on the date of valuation, the appraiser usually assumes that the substitute property will be *complete* as of this date and that the owner need merely settle his bill with the contractor (with allowance for interest on funds which he has already advanced) and walk into his property. This, at least, *seems* to be his assumption, although the appraisal literature is not explicit on the point; otherwise, how can one explain the appraiser's failure to allow for delay losses combined with his insistence on reversing the interest factor?

The subject deserves far more discussion than it has yet received from the appraisal engineers. But the author surmises that the reversal of the interest factor in favor of a higher valuation is taken as a partial offset to the omission of the incidental-loss factor. Appraisers, one must remember, seldom deem themselves qualified to estimate incidental losses. They may therefore rest content to treat these losses as if they were equal to interest during construction.

Cost of Substantially Identical Property May Measure Value Only on the Assumption That the Property Would Actually Be Replaced by a Virtual Replica.

Most physical properties are not replaced by properties of the same size, design, and materials. They are replaced by materially different properties of a more modern type, better designed to meet the owner's present needs or fancies. How many of our American railroad systems, street-railway systems, steel plants, apartment houses, office buildings, and university campuses would be replaced with virtual replicas if they were to be wiped out of existence overnight? Most of them, perhaps, would be replaced in *some* way. But the replacement would be one of substitution rather than of identical reproduction. With some of the properties the substitute would not vary materially from the original. With others, it would be so radically different in its nature that the new property would bear little physical resemblance to the old. Many of the existing steam railroads would not be rebuilt at all. Others would be located on entirely different rights of way. Still others would be electrified from the beginning, or would have two tracks instead of one, or one track instead of two. And so on.

In such cases, the hypothesis that the value of the existing property is derivable from the current cost of constructing or buying a substantially identical property is always invalid. The appraiser may still adhere to it if he believes that there is no *material* difference between the cost and efficiency of the different substitute and the cost and efficiency of the replica. But he cannot ignore the discrepancy if it is serious—otherwise he will be guilty of gross overvaluation.

When faced with a situation in which the property would clearly not be replaced with a substantially identical property, the appraiser may meet the issue in either of two ways. His most radical solution is entirely to ignore any estimate of replacement cost as a basis of valuation. His second alternative is to estimate the cost of buying or constructing that type of substitute property, however different from the original, which the owner would be most clearly justified in securing. This "cost of the best available substitute" would then be the relevant replacement cost for his purposes.

But even the cost of a different substitute cannot be accepted, without modification, as the measure of the value of the existing property. For the substitute would be almost sure to be better in some respects, and might well be worse in other respects, than the property which the owner is now using. Suppose, for example, that the appraiser is estimating the value of a steamship which has suffered no serious "physical depreciation," but which has become obsolescent

through a recent improvement in the arts of ship design. Suppose that a new type of steamship would have the advantage of greater speed with equal running expense, but the disadvantage of greater draft, with the result that its use would increase the risk and delays of entering the harbors for which the ship that is under valuation is likely to be used. Let us assume that this newer type of ship, despite its inconvenient draft, is the one which an owner would wisely prefer if he were to replace his existing ship. The value of the existing ship cannot be derived from the cost of the substitute ship without a deduction for the slower speed of the existing ship, and without an addition for its lighter draft.

Similarly, if the value of an existing electric-light plant is to be derived from the cost of producing a more modern plant, allowance must be made both for the superior virtues (say, lower operating expenses) and for the inferior qualities (say, risks of untried machinery) of the hypothetical substitute as compared to the existing property. A very nice appraisal problem—and one which calls for great engineering, accounting, and mathematical skill! If the problem is too complex, as well it may be, and if it involves too speculative forecasts as to the probable cost of a different substitute and as to the probable operating efficiency of this substitute, the appraiser should abandon his attempt to find value by reference to estimated replacement costs. But if he refuses to abandon the attempt and reverts to the estimated cost of an *identical* property, he is in danger of arriving at a wildly excessive valuation.

The very problem which we are now discussing has been before the courts on several occasions. It has been an especially acute issue in public-utility valuations for rate-making purposes, where the companies have contended that their properties should be valued primarily on the basis of cost of producing an almost identical property, but where the representatives of the ratepayers have contended that the only relevant replacement cost is cost of the most reasonable, modern substitute plant.

The Supreme Court faced this issue in the *Indianapolis Water* case,[13] where it sustained the company's contention that the estimated construction cost of that very type of property, and not of a differently constructed system, was the factor to be given "dominant weight" in the valuation. Justice Butler, who wrote the prevailing opinion, stated or intimated three different reasons for disregarding the city's estimates of the cost of a much less expensive but equally efficient substitute system. He first noted that the existing plant was well constructed and well designed to serve the city with an adequate water

[13] McCardle v. Indianapolis Water Co., 272 U.S. 400 (1926). See *infra* pp. 1124–1126.

supply. This statement may have been intended to throw doubt on the city's insistence that an equally efficient property could be constructed at a much lower cost, under a different engineering scheme. His second point was that a valuation based on the assumed cost of a different type of property is highly speculative and is therefore subject to that suspicion with which all speculative considerations bearing on value, or on damages, are treated by the courts. His third point was that the fact to be determined was the value of the *existing property*, not the cost or value of a hypothetical substitute property.

The first point raises questions of fact about the particular case which we need not consider here. Of course, if the city was wrong in contending that an equally efficient alternative system could have been constructed at much less expense, its particular objection to the use of cost of identical reproduction was also groundless. Moreover, the Court was doubtless justified in placing a fairly heavy burden of proof upon the city that a cheaper scheme of construction would have been feasible.

The second point is plausible; but it seems to ignore the fact that the valuation of any complicated business property is *necessarily* a highly speculative matter. If courts feel obliged to rule out estimated costs of different substitutes because of their speculative character, but if they still persist in admitting cost of producing a substantially identical property as evidence of value, they are almost certain to arrive, chronically, at serious overvaluations. Valuation *necessarily* involves speculation as to probabilities of future events. One of the strongest arguments against the attempt to base rates on the "present values" of utility properties is that the whole procedure is inevitably highly speculative.

The third point involves a fundamental error in the theory of appraisal. This has been pointed out by appraisal experts who have commented on Justice Butler's opinion. Even though the value of the *existing* property is conceded to be the "fact to be found," the reproduction cost must necessarily refer to the cost of a hypothetical, new property. This would be true even though the cost of reproducing an exact replica were assumed to be the relevant cost. One does not literally "reproduce" a property—one produces another property like it.

THE ESTIMATE OF REPRODUCTION COST

We have so far referred to the relevance of replacement cost as evidence of value. But what about the determination of replacement cost itself? Here is a problem of evidence that is often no less difficult than the primary one so far discussed. In many instances, to be sure, the question is readily answered with a reasonable approximation to

accuracy; especially so when the pertinent replacement cost is the cost of purchasing a standard type of commodity on the market place. There would be little difficulty in ascertaining the cost of replacing a pair of Hanan shoes on the retail market, or the cost of replacing ten shares of United States Steel common on the stock market.

But where the pertinent replacement cost is that of reconstruction rather than of market purchase, and where the structure in question is not of a standardized type, the most competent experts are likely to differ materially in their estimates. This is necessarily the case, since the estimates, like estimates of value itself, are forecasts as to what expenses would have to be incurred on the fictitious assumption that a new structure were to be erected. One can well imagine the errors involved in an attempt to predict the cost of reerecting the Woolworth Building, or of the Commonwealth Edison system, or of the New York Central Railroad. Even more critical obstacles are faced if the cost of constructing a differently designed and located substitute property is in question.

The technique of estimating reconstruction cost constitutes the central field of the appraisal engineer. It will not be explored in this study, partly because only a professional appraiser is competent to handle it, and partly because it can be intelligently treated only by reference to specific types of property. The standard method of estimate is based on the application of prevailing market prices for material, labor, and supervision, to the inventory of the structural units. But the heavy expense and delay involved in this method have led to the adoption of two short-cut devices, each of which has been used, on occasion, in court.

The first of these short-cut methods has been used most frequently in general property taxation, where the assessors' time and resources are so limited as to require extremely crude appraisals. It involves the selection of typical units of physical property by size—say, a 50-foot side lot of standard depth with respect to land, and a cubic foot of space with respect to buildings of a particular material and design. The replacement cost of the property is then assumed to equal the current price per unit, multiplied by the number of units of which the property is composed. We explain this method of appraisal at greater length in Chap. XVII, on valuation under the general property tax.

The second short-cut method is the index-number method, already mentioned in the preceding chapter.[14] Here the original construction cost of the property is taken as a basis, but this cost is revised upwards or downwards by the application of price-index numbers, designed to

[14] At p. 144.

take account of changed construction costs. In very crude replacement-cost estimates the original cost in gross is modified by a single index number, based on some average of the price changes in the more important cost components. But the obvious unreliability of any such procedure has given rise to more refined methods, whereby the attempt is made to determine the separate original component costs (cement, copper, common labor, etc.), to each of which a special index of price change is then applied. Still further refinements are sometimes undertaken, such as allowances for the increased or decreased efficiency of labor and of construction technique.

In the litigated cases, the index-number method has been most frequently used in public-utility valuations for rate-making purposes. But here, as will be noted in the chapters on rate-making value, there is much confusion as to the very significance of the revised original-cost estimates. Sometimes the witness or the tribunal that favors the use of index numbers seems to be doing so on the theory that original cost itself, with proper revisions for the changing cost of living, constitutes a better rate base than current replacement cost. At other times, the estimates are defended on the theory that they give a fair approximation to replacement cost while avoiding the expense and delay of the standard methods of appraisal. More frequently, the advocate straddles the two arguments for the index-number method, without recognizing that the one is inconsistent with the other.

Our present concern is solely with the index-number method as probative of prevailing replacement cost. On this point there is still much controversy in the appraisal profession. But the most authoritative opinion is that the method is a very poor substitute for a careful and expert estimate of replacement cost by the standard method, although it may constitute a useful check against a detailed appraisal.[15] Clever refinements in the index-number method are likely to do more harm than good; for they rob it of its relative ease and objectivity without greatly adding to its reliability.

THE ROLE OF REPLACEMENT COST IN THE APPRAISAL OF DIFFERENT TYPES OF PROPERTY

With proper allowances for the incidental-loss factor and for depreciation, the replacement-cost method is applicable, in theory, to every

[15] "Construction cost indices, like those for crop production, automobile accidents, life-mortality tables, etc., are interesting indicators of general movements, but are misleading if applied to a particular building, farm, automobile, or human life." American Appraisal Company, *Clients' Service Bull.*, Apr. 20, 1933. See also its *Bulletin* of May 1, 1934, and Henry W. Sweeney, "Approximation of Appraisal Values by Index Numbers," 13 *Harv. Bus. Rev.* 108–115 (1934).

valuation of replaceable property which is sufficiently serviceable to warrant replacement. Even in actual practice its role is wide, for it often plays its part in the guise of some apparently distinct basis of valuation. But whenever it requires highly speculative guesses as to the "best available substitute property," as to the incidental-loss factor, and as to the depreciation of old and obsolescent property, it loses its charm and invites competition from alternative methods.

Without reference to specific types of property and to particular fact situations, few generalizations as to its relative merits can be made. The reader must turn to the special monographs on appraisal, such as Frederick M. Babcock on real estate, Herbert Hoover on mines, and Graham and Dodd on securities, for close analysis in each respective field.[16] But brief comments may be made as to the role of replacement-cost estimates in various types of appraisal where market value or value to the owner is the objective.

Marketable Chattels.

Properties of this type (merchandise, raw materials, etc.) are usually valued at "market value" measured by current price quotations. But in the law of damages, the question has often arisen whether the value should be set at the plaintiff's *selling* price or at his *buying* price. When the plaintiff is a dealer or a consumer (as distinct from a manufacturer), the buying price is usually accepted; although some courts have turned to selling price when the commodities were irreplaceable save after critical delay. On the whole, the rulings are consistent with the replacement-cost method, except that they make no allowance for incidental damages, save under special circumstances. Even then, the incidental damage is traditionally thought of as something independent of the value of the property. For a detailed treatment of these cases the reader is referred to our chapters on the law of damages.

Vacant Land.

Save on rare occasions, neither the appraisers nor the courts think of land values as determined by replacement cost. "Market value" or "fair market value" is the assumed desideratum, and it is estimated by the recent selling prices of similar land, modified by the appraiser's judgment as to the peculiar adaptability of the land in question and as to the future trend of the real-estate market.

[16] Consult, also, the current bulletins of the American Appraisal Company for a very able defense of replacement-cost estimates in the valuation of real estate and of industrial plants. These bulletins supply a much-needed antidote for the prevalent assumption that replacement costs are irrelevant and that the appraisal should be based solely on the record of earnings.

It is commonly said that land is irreplaceable and hence that the replacement-cost method is inapplicable. But the former statement is inaccurate, save with respect to those rare locations that can be called "unique"—reservoir sites, mountain passes, preferred sites for resort hotels, etc. With the standard types of land, the scant courtesy given to replacement cost is due to the typical absence of a distinct spread between realization price and cost of replacement—such a spread as exists between the scrap value of a fixed asset and its "value to the going concern." With land, the values inferred from current sales of similar land are rough approximations to replacement cost no less than to realization price. The traditional land valuation is, therefore, not notably inconsistent with the replacement-cost theory.

Improved Real Estate.

Here we come to a major controversy among the appraisers. The orthodox appraisal is based on the estimated market value of the vacant land plus the estimated depreciated replacement cost of the structures. But Frederick M. Babcock's treatise on *The Valuation of Real Estate*, by all means the ablest on the subject, reflects the modern trend of thought by belittling the significance of replacement cost save as setting an upper limit beyond which improved realty should not ordinarily be valued. Instead, he contends, the property should be valued as an organic whole by reference to estimated annual rent value or estimated profits derivable from the use of the property. Whenever it is necessary to estimate the value of the building itself, this value can best be measured by the difference between the value of the entire property and the vacant-land value.

Babcock has perhaps somewhat underrated the usefulness of the replacement-cost method when applied with full allowance for all forms of depreciation, including obsolescence and inadaptability. But his views are essentially in accord with those expressed in the present chapter, which holds that the value of property is measured by whichever valuation is distinctly *lower*—that reached by the replacement-cost method or that reached by the capitalized-income method.

Fixed Assets.

The replacement-cost method plays an indispensable role in the valuation of a specific fixed asset, or group of assets, of a complex, solvent business enterprise. Here, almost invariably, the pertinent value is "value to the going concern" (a form of value to the owner) rather than market value in the strict sense of realization price. Were it not for the possibility of replacement, a single rail on the

main line of a railroad might be worth one hundred million dollars, and the bus bar of an electrical-utility system might be worth almost as much as the entire enterprise is worth. Any attempt to value the asset by assigning to it some "fair share" of the earning power of the organic enterprise is utterly invalid from an appraisal standpoint, since it involves the false assumption of an equation between the value of the whole going concern and the sum of the values of the individual parts. The alternative assumption, that the value of a fixed asset is normally measured by *original* cost as distinct from current *replacement* cost, is subject to other objections stated in the previous chapter.

The Entire Physical Plant of a Business Enterprise.

In the appraisal of industrial or public-utility properties, it is often the assumed object to determine the value of the entire physical plant as distinct, not only from the enterprise or company which possesses the plant, but also from the individual assets. Even so, to be sure, an appraiser may evaluate the assets or the enterprise; but only as a step in arriving at the value of the third form of property, the organic, physical plant. Here, indeed, is a nice problem—the valuation of the forest, but neither of the trees on the one hand nor of the lumber company on the other hand!

In an assignment of this nature, the orthodox procedure is to build up the valuation of the plant by what purports to be a summation of the separately appraised values of the assets. But such a procedure, were it followed literally, would reach ridiculous results, for it would lead to a grossly excessive valuation of the entire plant. Almost never is a unitary plant worth as much as the sum of the values of its separate parts, valued as parts of the whole rather than at their separate realization values.[17]

In a measure, this point is well recognized in modern appraisal. But its full implications have seldom been accepted with logical rigor; indeed, they have never been analyzed adequately in theory. The appraiser, in deriving the value of a plant by the replacement-cost method, should calculate all of his factors (replacement cost new, allowance for damages due to delayed replacement, and allowance for depreciation) by contemplating replacement *in toto* rather than piecemeal reconstruction. None of these factors can be assumed to equal the sum of the same factors as calculated for the individual assets. Complete reconstruction may be either more or less costly than piece

[17] For discussions of this point see *supra* pp. 76–82, and *infra* pp. 677–691.

meal reconstruction; the incidental-loss factor may be either more or less serious under the one assumption than under the other; the depreciation of an organic plant is typically very much in excess of the sum of the items of depreciation of the individual parts—a point to be discussed in the following chapter.

With proper revisions in the estimates of the above-mentioned factors, the replacement-cost method is theoretically applicable to the valuation of an entire physical plant whenever the plant, were it to be totally destroyed, would be worth replacing. But the calculation of these factors involves so much speculation that the significance of such an appraisal is highly doubtful.

Unfortunately, however, no alternative method of appraisal will do the trick, except in those cases where the destruction of the plant would mean, in effect, the destruction of the entire enterprise. In the latter event, the plant alone is worth as much as the whole enterprise is worth, minus the realization value of the current assets. But if the destruction of the plant would still leave the enterprise with a large going value which could be preserved by the acquisition of a new plant, the old plant can be appraised, if at all, only by the replacement-cost method. A conclusion that the task is too formidable calls for the further conclusion that the value of the plant is unmeasurable. Precisely this conclusion is unavoidable, in the present stage of appraisal technique, with respect to most modern industrial, railroad, and public-utility properties.

Business Enterprises.

Except for assets and commodities that are, from a practical standpoint, irreplaceable, the replacement-cost method plays its most restricted role in the valuation of an entire business enterprise or of a security issue of a corporate enterprise. So far as concerns the whole enterprise, it is seldom worth while for the appraiser to contemplate its replacement by another, substantially similar enterprise. For practical purposes the more plausible assumption is that the owner who loses the enterprise (or the bidder who fails to buy it) will simply do without that type of property and will resort to the general market for an alternative investment. The enterprise is therefore valued at its capitalized anticipated earning power. But even the capitalized-income method, which will be treated in a later chapter, is a kind of a replacement-cost method. It differs from this latter method as usually construed, by assuming a replacement of monetary income rather than a replacement of specific instruments for the acquisition of this income.

Securities.

In litigations, *marketable* securities are generally appraised at their current market value as "measured" by the current market prices of ordinary lots of securities of the same issue. Usually these prices reflect the approximate replacement costs of the particular security issue, and their adoption is consistent with the replacement-cost method. But when an appraiser is called upon to value an extraordinarily large stockholding, he must consider the dual possibility that the stock could be sold only at a discount and bought only at a premium. The logic of the replacement-cost method would require a choice of the latter figure; and this choice is indeed required if (*a*) the appraisal is designed to disclose the value of the stock to any given owner and if (*b*) the owner would clearly be warranted in paying the required premium for such a large commitment. But the courts, quite properly, are loath to make guesses as to the special value of a marketable security to any specific owner, and they generally take the current price quotations without premium for enhanced replacement cost and without discount for impaired marketability.[18] Extreme cases, such as those in which the stock has an unusually high and provable value for purposes of control, present hard questions of law on which there are few precedents.

Replacement cost is seldom acceptable as a basis of valuation for unmarketable securities. It is generally ruled out, first, because it cannot be estimated with confidence, and second, because the wisdom of making the replacement is doubtful. An appraiser is not often justified in assuming that a stockholder, were he to be deprived of ten shares of an inactive stock, would rationally replace them by purchasing ten other shares of the same stock.

The Limited Role of Replacement Cost as a Measure of "Warranted Selling Price" or "Intrinsic Value."

Let it be recalled that, throughout this chapter, we have been discussing the role of replacement cost as a measure of two specific kinds of value—market value, defined as the price for which the owner could presently sell his property; and value to the owner (or "to the going concern"), defined as the amount of money that would precisely indemnify the owner for the loss or destruction of his property. Under *either* of these assignments, the primary significance of replacement cost is that (with qualifications) it sets the upper limit of value.

But many appraisers do not construe "value" in either of these two senses. The security analyst, for example, seeks "intrinsic

[18] See *infra* pp. 716–719, 1035–1036.

value," and the real-estate appraiser seeks what he often *calls* "fair market value" but what Babcock more aptly terms "warranted selling price."[19] The security analyst may declare that the current market price (and hence the replacement cost) of United States Steel common is above or below its "intrinsic value," whereas the real-estate appraiser may estimate that an office-building property is "worth" $1,000,000 even though, at the present time, it is concededly salable (or replaceable) at only $800,000 on the one hand or at $1,200,000 on the other hand.

Under this elusive interpretation of "value," the significance of replacement-cost estimates becomes highly indirect and indeterminate. For here the appraiser is acting as a *critic* of current market prices, and his criticism may embrace the very prices that enter into a determination of current replacement cost. Consider, for example, the valuation of 100 shares of United States Steel common on a day when the stock-market quotations are in the neighborhood of 50. If the object of the appraisal is to determine present market value, these quotations settle the issue within a narrow margin of error. Similarly, if the object is to determine the present value of the stock to any particular owner, the stock ticker sets the upper limit of value, since it indicates the restitution price. But if the "intrinsic value" or "*proper* selling price" of the stock is in question, neither current replacement price nor current realization price is final. On the contrary, the reasonableness of these (here almost identical) prices is the very question at issue.

Recognizing this situation, appraisers who construe their task as one of criticizing market-fixed values rather than merely as one of discovering them, and who use "value" to mean "what the value ought to be," make much less direct use of replacement-cost data than do appraisers who are estimating either market value in a strict sense, or value to the owner. To be sure, the field within which they can reject the verdict of the current market is a very limited one—limited, as a rule, to the selling prices and replacement costs of properties of a highly similar nature. In the main, they attempt merely to align the "warranted prices" of the property in question (United States Steel common, or this particular office-building property) with the prevailing prices of similar properties (other high-grade steel stocks and other office-building properties or, perhaps, *all* other real-estate investments). But their basis of alignment is a comparison of relative, long-run, income expectancies rather than a comparison of current replacement costs. To the extent that they consider reproduction costs, they

[19] See *supra* pp. 24–29, 62–64.

attempt to estimate *normal* costs rather than evanescent, current costs.

The reader should bear in mind the special concept of "value" accepted by those modern appraisal treatises, like that of Babcock, which belittle the significance of replacement-cost estimates. This warning is important to the student of legal valuation; for it is by no means clear that the courts are usually concerned with a "fair value" which disagrees notably with the current verdict of the market place. Unfortunately, the courts are hazy on this issue, as their distinctions between "market value," "fair market value," and "intrinsic value" are very indefinite.[20]

Replacement Cost Sometimes a Better Basis of Valuation than Value Itself.

We must again recur to the point that, through a paradox of the English language, a valuation is not always designed to measure actual "value" in any nice sense of that word. There may be legal situations where property should be valued "for the purposes of the case" at its replacement cost of, say, $10,000, even though it is concededly worth only $5,000 on the market place or to its present owner. Such a situation might arise, for example, in an appraisal of property purchased under a contractual agreement whereby the buyer agrees to pay a price measured by replacement cost minus stipulated deductions for physical depreciation.[21] Or it would arise under a tax statute which first states that property must be assessed at its "full value" but which proceeds to define "value" in terms of replacement cost. Instances of this clear-cut identification of value with replacement cost are rare in the law. But the law supplies many examples of confused standards of value, in that the statutes or common-law traditions apparently make use of the word "value" as a vague hybrid term which is not exactly replacement cost on the one hand, and not exactly commercial value on the other hand. Our chapters on property-tax assessments give instances in point (Chaps. XVII and XVIII).

[20] Strange to say, the notion of "intrinsic value," which leads some appraisal experts to belittle the significance of current replacement costs, has led some courts to identify value with reproduction cost minus conventional allowances for physical depreciation. See *infra* pp. 393–394.

[21] See Low Estate Co. v. Lederer Realty Corp., 35 R.I. 352, 86 Atl. 881 (1913), involving the appraisal of a building erected by the lessees of the land under an agreement whereby the lessors were to buy the building at the end of the term, at its appraisal value. *Held*, that the parties must have contemplated an appraisal at "sound value" (depreciated reproduction cost).

In public-utility valuation for rate-making purposes, replacement cost has generally been held to constitute the dominant "element of value," although original cost is "taken into account." But, although the courts have here purported to accept replacement cost merely as *evidence* of value, those economists who have defended this basis of rate making have done so, not on the ground that it measures value, but on the very different ground that it constitutes a desirable rate base on its own merits.[22] Even in property taxation, a plausible argument can be made for the use of replacement cost and *not* value as the tax base.[23]

SUMMARY

The question to which this chapter has undertaken a general answer may be stated as follows. Why, and under what circumstances, is an appraiser justified in taking into account the current cost of replacing any given property as bearing some measurable relationship to its value?

Two quite different theories of relevance have been noted, the competitive-price theory and the theory or law of substitution. According to the classical economists' doctrine of competitive prices, the market values of commodities, when produced and marketed under conditions of competition, tend to equal production costs—that is to say, reproduction costs. This tendency is constantly interfered with by distrubing forces, with the result that wide discrepancies between market values and production costs are the usual phenomenon. But if the appraiser has no better basis for a valuation, an assumption that the value of a given property equals its reproduction cost has a greater claim to acceptance than would a blind guess or a figure suggested by a fortune teller.

Rarely, however, is an appraiser in such a dire predicament. He would therefore seldom make direct use of replacement-cost data were it not for the second theory of relevance, based on the principle of substitution. According to this principle, no given property can be worth more than the cost of acquiring equally desirable substitute property. Hence we have one of the most useful single generalizations in appraisal theory—that replacement cost ordinarily fixes the upper limit of value. But since instantaneous replacement is out of the question, many exceptions must be recognized where the unavoidable delay would be serious to the owner or prospective buyer of the prop-

[22] See *infra* pp. 1086–1089.
[23] See *infra* pp. 459–460, 520–521.

erty whose replacement is contemplated. In such cases, the existing property may be worth much more than its replacement cost.

While, with qualifications, replacement cost fixes the *maximum* value of the property, it is not acceptable as a measure of value itself unless the appraiser has adequate reason to believe that the property is worth replacing. If this question is in doubt, the appraiser must try to answer it by determining the income derivable from the property.

A sharp distinction must be drawn between replacement cost in the sense of the cost of acquiring a substantially identical type of property, and replacement cost in the sense of the cost of constructing or buying the most desirable substitute. The former is never a measure of value unless it happens to approximate the latter. But even the cost of a different type of substitute cannot be used directly as a measure of value. Account must be taken of the likelihood that in some respects the substitute would be superior to the present property, while in other respects it would be inferior. More will be said on this point in the following chapter, on depreciation.

We conclude that replacement cost has a very important bearing on value, but that the relationship between the two items is so complex that inferences are dangerous unless drawn by an appraiser of the highest skill. The assumption, often reflected in the opinions of the highest courts, that replaceable property is *usually* worth its replacement cost, minus conventional deductions for depreciation, is utterly unwarranted and is constantly belied by business experience. A far safer generalization is that property is worth some amount between zero as a minimum, and replacement cost, plus allowance for delayed replacement, as a maximum.

But even this generalization holds true only when "value" is taken to mean either market value or value to the owner. For example, in the determination of "intrinsic value" as construed by appraisers, current replacement cost has little direct significance; whereas, under one theory of public-utility valuation for rate-making purposes, depreciated replacement cost *is* the "value for the purposes of the case."

CHAPTER X

DEPRECIATION AS A DEDUCTION FROM REPLACEMENT COST NEW

The preceding chapter has explained the principle, now generally accepted by the appraisal profession, that the replacement cost of property has no direct bearing on its value unless replacement would be warranted if the property were to be destroyed or alienated. But even if the property would be worth replacing, its value can seldom be assumed precisely to equal replacement cost. There must always be considered the possible necessity of making two adjustments: first, an allowance for the "incidental damage" that would be imposed by the delay and interference due to the process of replacement; second, an allowance for depreciation. The former adjustment requires an addition to the replacement-cost estimate; the latter adjustment requires a deduction therefrom.

As to the incidental-damage factor nothing more will be said, save for a section of the present chapter on its bearing on the calculation of depreciation. But depreciation itself requires detailed study. While the necessity of "taking it into account" is now firmly established in legal tradition, the cases still reveal the sharpest disputes as to its nature and measurement.[1] These disputes are not confined to the law; even among the experts, depreciation is today the most controversial subject in the whole realm of appraisal.

The reader's attention is drawn to the restricted title of the present chapter—"depreciation *as a deduction from replacement cost new.*" This restriction is by no means intended to imply that the necessity of allowing for depreciation arises only when the value of property is derived from an estimate of replacement cost. On the contrary, the depreciation factor must be taken into account in a valuation based on actual sales, on original cost, on capitalized earnings, or on any alternative basis. For example, when the present value of a 2-year-old building is to be inferred from its actual construction cost, account must be taken of any depreciation in value that has occurred during the intervening period. And when the value of a business enterprise is to

[1] For discussions of the legal opinions in various types of litigation, see index under "Depreciation."

be based on a capitalization of its annual net earnings, a proper allowance for annual depreciation must be included in the figures from which these net earnings are derived. (In the latter case, the question what constitutes a "proper allowance" is one of extreme difficulty, as will be pointed out in Chap. XII, on enterprise valuation.) But the particular method or basis of valuation that is chosen for the appraisal at hand has a vital effect, not only on the technique of estimating depreciation but also on the very meaning assigned to the term "depreciation" itself. In order to avoid confusion, the present chapter will therefore confine itself largely to the problem of defining and measuring depreciation as an abatement from replacement cost new.

The Controversial Nature of Depreciation.

Why is depreciation such a controversial subject in law and in commercial appraisal? In part the answer is to be found in the inherent difficulties of *measurement*—difficulties of which no experts have yet found satisfactory solutions. It is no easy matter to determine the influence on property values of the phenomena of wear and tear, obsolescence, and inadequacy. Even the purely theoretical aspects of the problem require a resort to formulas understood only by higher mathematicians. Indeed, Hotelling states that certain situations call for the development of formulas that await the further progress of pure mathematics itself.[2] In such realms of science the practical appraisers and accountants, like the present author, are lost. Far more serious is the absence of reliable data on the life histories of different types of assets, from which forecasts may be made as to the probable future life experience of the property which is being valued and of the substitute property which serves as a basis of comparison.

But despite all these inherent technical difficulties of estimating depreciation in quantitative terms, most of the controversies that get into court, and even into some of the textbooks on appraisal and accountancy, are of a more elementary nature. They are due either to disagreement or to a lack of clarity as to the meaning of "value" as the thing which is *affected* by depreciation. So serious is this confusion of opinion as to the object of the inquiry, that the most difficult eviden-

[2] Harold Hotelling, "A General Mathematical Theory of Depreciation," 20 *Jour. Am. Stat. Assn.* 340–353 (1925). For other mathematical treatments see Hotelling, "The Economics of Exhaustible Resources," 39 *Jour. Pol. Econ.* 137–175 (1931); Charles F. Roos, "A Mathematical Theory of Depreciation and Replacement," 50 *Am. Jour. Math.* 147–157 (1928), and "The Problem of Depreciation in the Calculus of Variables," *Bull. Am. Math. Soc.*, March–April, 1928, pp. 218–228; J. S. Taylor, "A Statistical Theory of Depreciation Based on Unit Cost," 18 *Jour. Am. Stat. Assn.* 1010–1023 (1923).

tiary problems are not even sharply drawn in the litigated cases. The disputants and the judges do not get far enough in their analysis fully to recognize and explain their character. These remarks will be amplified in the following section, on the meaning of depreciation.

THE VARIOUS MEANINGS OF DEPRECIATION

Confusion of Meanings.

The serious confusion of thought resulting from the use of depreciation in many different senses is well recognized in the current literature. Kester[3] quotes as follows from a report of a special committee of the American Society of Civil Engineers:

> Perhaps there is no single subject in connection with valuation that has caused more trouble than depreciation. This has been due to various causes, perhaps not the least of which has been confusion in the use of the term.

Schultz[4] stresses the same point by a quotation from Sanford Robinson, who testified at hearings on the subject before the Interstate Commerce Commission:

> For fifteen years we [the commission and the carriers] have had conferences and arguments, and today it seems that we are not any nearer to the definition of "depreciation" than when we began, and I think a great deal of our confusion results from this.

Later we shall distinguish four basic concepts of depreciation, also noting various subconcepts. Meanwhile we may point out how a dispute as to the meaning of depreciation may affect the value placed upon a given property.

The valuation of structures and equipment, to determine recoverable damages by fire insured against, is governed by statutory provisions embodied in standard fire-insurance contracts.[5] In New York State and elsewhere, recovery is limited to a value not in excess of replacement cost minus an allowance for depreciation, and this upper limit has sometimes been supposed in effect to determine the actual recovery for complete destruction. But what does the statute mean by "depreciation"? To some appraisers and judges, the term has meant merely "physical depreciation" as distinct from obsolescence and other "functional" detriments. Influenced by this limited meaning of the word and by an ambiguous early opinion of the Court of Appeals, the lower New York courts were formerly disposed to allow no deductions

[3] Roy B. Kester, *Advanced Accounting* (3d rev. ed., New York, 1933), p. 221.

[4] Robert Schultz, *Depreciation and the American Railroads* (Philadelphia, 1934), p. 9.

[5] *Infra* p. 367–368.

save for wear and tear and decrepitude. They therefore held that a brewery, burned down after the National Prohibition Act had taken effect, must be valued without reference to this purely "functional" decline in its commercial value. But the decision was reversed by the Court of Appeals, which refused to construe "depreciation" so narrowly.[6]

A somewhat similar issue arose in two other fire-insurance cases already mentioned in an earlier chapter,[7] where both a state court and a Federal court declined to take cognizance of a fall in the value of a building resulting from a purchase of the site under an agreement whereby the owner was permitted to move the building to another site. The judges declared, in effect, that the functional impairment of the building did not constitute a depreciation of "real" or "intrinsic" value.

The public-utility rate cases furnish many illustrations of disputes turning on the "true meaning" of depreciation.[8] In these cases it is now a well-settled legal doctrine that depreciation must be deducted from replacement cost new before this cost may be accepted as a measure of "present value." But how broadly "depreciation" must be construed is still a highly moot question. Consequently, public-utility counsel have been alert to narrow the term in every conceivable way. They have argued that depreciation does not cover obsolescence; that it covers only "realized depreciation" (measured merely by loss of *present* efficiency) and not "theoretical depreciation" (which takes cognizance of *prospective* loss of efficiency); that it properly includes only those ordinary impairments in value for which a well-managed company can fairly be expected to make advance provision, thereby excluding extraordinary obsolescence; that it refers merely to those elements of deterioration which can be observed by an engineering inspector, thus excluding invisible depreciation; that it is a mere synonym for undermaintenance; and so on indefinitely. All of these arguments are buttressed by references to authoritative statements as to what depreciation "really means."

Confusion Due to Ill-defined Concepts of Value.

The use of depreciation in different senses would hardly result in serious trouble, were it not for the controversial meaning of "value of the property" as the ultimate "fact to be found." This point may be made clear by illustrations of cases, real or hypothetical, in which value

[6] McAnarney v. Newark Fire Insurance Co., 247 N.Y. 176, 159 N.E. 902 (1928), discussed *infra* pp. 389–392.

[7] The Washington Mills cases. See *supra* pp. 21–22 and *infra* pp. 392–394.

[8] See *infra* pp. 1126–1140.

is so clearly defined that the proper interpretation of depreciation is self-evident.

Consider first, the brewery-valuation case mentioned above, in which the dispute turned on the question whether "depreciation" includes obsolescence due to the passage of a prohibition law. Assume that in fire-insurance cases, value is held invariably to mean market value, defined as the price at which the owner of the insured property might have sold it to some actual buyer, as of the time just preceding the fire. Under such a definition of value, it would be mere nonsense to contend, as did the owner of the brewery, that obsolescence should be ignored. By very definition, the court would be compelled to take into account every phenomenon, regardless of its nature, affecting the price which a buyer would pay for the property. To be sure, some appraisers might still make a verbal distinction between depreciation and obsolescence. But this terminology would not affect the valuation; it would merely require the appraiser to consider the latter phenomenon under a different name.

Assume, now, that value, in an action to recover for insured losses, is interpreted to mean, not market value, but rather the special value of the property to the owner himself. Here, too, obsolescence must be considered, as must every other phenomenon affecting the payment which would recompense the owner for the loss of his property. In the brewery case, the same deduction for depreciation might well be called for that would be required if market value were the desideratum. But one can easily think of examples where a depreciation in market value is different from a depreciation in value to the owner. The market value of many types of property falls off more rapidly with use than does the value of that same property to the owner himself. This peculiar depreciation in market value must be fully allowed for in some types of appraisal, whereas it may properly be ignored in other types.[9]

Finally, let us assume an arbitration case for the purpose of fixing the purchase price of a factory bought under a contractual agreement whereby the buyer has promised to pay its "appraised value" as measured by current replacement cost with no allowance for depreciation of any kind. Here value, by very stipulation, *means* replacement cost new, and the question of depreciation is literally irrelevant. Actual stipulations of this extreme form have never come to the writer's attention; but binding agreements *limiting* the allowance for depreciation are by no means unfamiliar in business practice. Usually,

[9] This point is well recognized in appraisal and accountancy. See, for example, Kester, *Advanced Accounting* (3d rev. ed., New York, 1933), p. 222.

however, they are not adroitly drafted, with the result that the interpretation of deductible depreciation gives trouble.[10]

In most of the litigated cases, the precise meaning of "value of the property" is far from predetermined at the time when the disputants argue the depreciation question. In consequence, this latter dispute carries with it a serious intermixture of problems that, from a scientific standpoint, should already have been disposed of. This difficulty is often present even when a court holds that the value in question is market value or fair market value. Not being ready to identify fair market value with actual selling price, the courts tend to confuse the question, What depreciation has actually been sustained? with the question, What depreciation may *fairly* be deducted in settling the rival claims of the two parties?

Even more serious difficulty arises when the courts find it necessary to invoke some concept of value expressly distinguished from market value. In the fire-insurance cases, for example, one finds reference to a mythical concept of intrinsic value, which is supposed to be affected adversely by "physical depreciation" but not by obsolescence or other "functional" factors.

The lack of any definite concept of "value of the property" makes a hocus-pocus out of the controversies as to the proper deductions for depreciation in public-utility rate cases. Consider, for example, the argument frequently made by public-utility counsel, that unexpected, accidental types of obsolescence should not detract from the rate base, because the company was in no position to have provided against them through prior charges to income account. This contention is plausible—conceivably it is conclusive. Yet it involves no problem of depreciation from an appraiser's standpoint, since by admission the depreciation exists, and since the only question is, "What should a court or commission do about it?" Yet in practice the two problems get hopelessly intertwined, partly because they are actually confused by counsel and witnesses, but also partly because counsel believes that obfuscation may help win the case. The most persuasive argument against a deduction for depreciation is the combined one that the depreciation does not really exist, and that anyhow its existence should be overlooked!

[10] As where the agreed terms of a corporate merger provide for a valuation of the constituents' plants at their "sound value" or at their "replacement cost minus physical depreciation." In the famous British telephone-purchase case, the purchase agreement contained certain stipulations as to the basis of valuation which had an ill-defined bearing on the allowance for depreciation. National Telephone Co., Ltd. v. H. M. Postmaster-General, 29 T. L.R. 190 (1913).

We conclude, then, that disagreement as to the meaning of depreciation is only a symptom of the basic trouble. The malady itself is the failure to agree on the answer to the more fundamental question, What is meant by value?

Four Basic Concepts of Depreciation.

The standard, lexicographer's definition of depreciation is "fall in value." Far more frequently, however, the word is used in special senses by accountants and appraisers. Substantially all of these technical meanings are variants of four basic concepts, which may be designated (*a*) impaired serviceableness, (*b*) fall in value, (*c*) difference in value, and (*d*) amortized cost.

First Sense: Impaired Serviceableness.

In its most primitive sense, depreciation is not a value category at all and cannot be expressed in terms of dollars. It means simply impairment of serviceableness, or utility, or efficiency. Thus, a rusty steel tool may be said to be depreciated if the rust impairs its efficiency. By invoking the notion of *relative* utility, one may extend depreciation to cover obsolescence. The old reciprocating steam engine may be just as efficient as it ever was; but as compared to a modern turbine it may have become *relatively* inefficient.

The fact that depreciation, when referring to impaired efficiency, is not a value category, will be clear to anyone who is familiar with the economic distinction between utility and value.[11] But it has not always been recognized in litigations. In valuations for rate-making purposes, representatives of public utilities have frequently argued that an old steam engine should be valued at replacement cost new, since it is "just as good as new." The assumption that "just as good as new" means "just as valuable as ever" is an error as serious as it is popular.

Second Sense: Fall in Value.

The phenomenon of deterioration, which is depreciation in sense number one, may be responsible for a decline in value, which is depreciation in sense number two. When thus used without restriction, depreciation is exactly interchangeable with "fall in value," and its meaning shifts with the shift in the meaning of value itself. For example, I may say that my investments have depreciated 50 per cent since the date of their purchase (referring to market value); or that my factory has depreciated 20 per cent in view of a drop in the demand for my products (referring to value to me).

[11] *Supra* pp. 16–18.

Even those accountants and appraisers, however, who define depreciation in terms of fall in value, seldom use it thus without restriction. Ordinarily they limit it to those declines in value which they attribute to certain specific causes associated with what Hatfield, referring to machinery and similar assets, calls the "irresistible march to the junk heap."[12]

The most generally excluded item is a "mere" fall in market price or replacement cost due to fluctuations in prices unrelated to the age of the asset. But many writers introduce still further restrictions. Some of them reserve the term "depreciation" for "structural depreciation." What other appraisers would call "depreciation, *including* obsolescence," they would call "depreciation *and* obsolescence." Sometimes the "depletion" of wasting assets (mines, etc., with nonrenewable resources) is set off in a separate category, as it is under the Federal Income Tax Law and in current textbooks on accountancy. But there is no uniformity of usage in these matters of terminology.

The distinction between depreciation and fall in replacement cost deserves special mention, as it may be confusing unless the reasons for making it are explained. But the reason applicable to standard accounting is quite different from the reason applicable to commercial appraisal. Orthodox accounting does not ordinarily take cognizance of the fall in the value of a fixed asset due to a decline in current market prices. Its allowances for depreciation are designed simply to charge off the original cost of the asset over the period of its useful life, not to allow for the entire difference between original cost and present value. Accordingly, price changes are traditionally ignored for balance-sheet purposes.[13] On the other hand, the engineering appraiser has already taken account of price changes when he has estimated the current replacement cost of the property. His allowance for depreciation is therefore a *further* adjustment, made necessary in order to equate the difference between the present value of the property in question and the present value of a hypothetical, new property purchased at current market prices.

Third Sense: Difference between the Present Value of the Old Property and the Present Value of a Hypothetical, New Property.

For the most part, the appraisers have borrowed their definitions of depreciation from the older profession of accountancy. But the accounting terminology has been devised for materially different ends from those of an engineering valuation. By and large, the

[12] Henry Rand Hatfield, *Accounting* (New York, 1928), p. 130.

[13] Except, sometimes, for the recalculation of salvage value.

accountant's attention is directed to the waning value of a depreciating asset over a given period of time. Accordingly, in so far as he construes depreciation in truly valuational terms, he thinks of it as a decline in the value of a given asset as between an earlier date and a later date—as between the time of acquisition and the time of retirement, or as between the beginning and the end of a particular year.

Following the tradition of accountancy, most appraisers *talk* about depreciation in terms of a fall in value. Indeed, they really *think* in these terms on those somewhat rare occasions when they determine the present value of an asset by adding to or subtracting from original cost. Far more frequently, however, depreciation is treated as a deduction from replacement cost new, estimated as of the date of the valuation. Here the definition "fall in value" is quite erroneous, and the fact that it is still current has given rise to serious confusion. Depreciation should now refer to the difference between the present worth of the old and obsolescent asset and the present worth of the hypothetical, new and modern asset. This difference may be much greater or much less than the *decline* in the value of the former asset. To be sure, even in estimating the differential value, an appraiser must, in effect, compare the probable future decline in the value of the old asset with the probable future decline in the value of the new one. But his ultimate objective is to contrast the values of two properties *as of the same date.*

One of the gains that would result from this revised mode of speech would be a clear recognition that the popular distinction between "physical" and "functional" depreciation is a false antithesis. *Any* depreciation of a physical asset, so far as it need be considered by an appraiser, is at once physical and functional. Consider two dynamos, the one of which is depreciated because its commutator has worn out and its insulation has become defective, whereas the other is depreciated because a more efficiently designed substitute is now on the market. Ordinarily the former depreciation would be called "physical" or "structural," whereas the latter would be called "functional." Clearly, however, the obsolescence is no less physical than the wear and tear; for a difference in design is certainly physical or structural in nature. Moreover, the wear and tear has a functional significance; otherwise it would be of no concern to an appraiser.

Fourth Sense: Amortized Cost.

We have finally to note a fourth concept of depreciation—one peculiar to accounting and hence sometimes called "the accounting concept." Here, depreciation is construed in terms, not of value but

of cost.[14] It refers to that part of the cost of an old asset which should have been written off from capital account and charged to income account or to some special reserve. "Amortized cost" is perhaps the most acceptable characterization. But even this phrase must here be construed factitiously to mean, not necessarily the cost that has actually been charged to capital account by the company's auditors, but rather such cost as *should* have been charged in accordance with accepted accounting principles. "Off-chargeable capital outlay" would be a better term, were it not so offensive to the King's English.[15]

One might suppose that there would be no quantitative difference between the fall in the value of a depreciating asset and the share of the cost of that asset which should have been written off the books. For is it not the very object of a depreciation account to build up a reserve which, when deducted from the gross book values of the fixed assets, will portray their remaining present values?

The answer to this last question is negative. Depreciation accounts are designed to provide a systematic method whereby the cost of the fixed assets is gradually transferred from capital account to income account (or to some other account) over the period of useful life of the property. The methods of determining these rates of conversion (straight-line method, sinking-fund method, etc.) are designed to secure some very *rough* correlation between the annual charge on the one hand and the annual fall in value on the other hand. But no attempt is made to secure a close correlation. Indeed, orthodox accounting declines to readjust the depreciation allowance by reference

[14] The vital importance of this distinction between "depreciation" in the sense of fall of value, and "depreciation" in the sense of amortized cost, is well recognized by John Bauer. "Depreciation," 5 *Ency. Soc. Sciences* 98. But it is inadequately perceived by writers who fail to observe the sharp distinction between cost and value. They blur together the two latter concepts, under such Janus-faced terms as "cost value," and they accordingly do not differentiate between a loss in value and an amortization or write-down of capital outlay. Leake's otherwise admirable monograph on depreciation suffers seriously from this defect. P. D. Leake, *Depreciation and Wasting Assets* (3d ed., London, 1920). The Interstate Commerce Commission was formerly guilty of the same confusion, if one may judge from its definition of depreciation as "lessening in cost value" (I.C C., Valuation Docket No. 2, p. 125). Even its more recent definition, in terms of "loss in service value" [Telephone and Railroad Depreciation Charges, 177 I.C.C. 351 at 422 (1931)] is unsatisfactory in the absence of a satisfactory definition of "service value."

[15] Leake's term "expired capital outlay" has gained currency. But it is inaccurate; for if an outlay can be said to "expire" at all, it expires when it is made and not when the acquired asset wanes in value. Irving Fisher emphasizes this important point by insisting that depreciation is not outgo or negative income. *Capital and Income* (New York, 1906), p. 234.

to the changing replacement costs of the depreciating asset. It follows that the depreciation which is shown, and properly shown, on the books of a company may be much higher or much lower than the depreciation which an appraiser should deduct in estimating the present commercial value of the property.[16] The force of this point has frequently been recognized in litigations concerned with corporate mergers, payments of dissenting stockholders, and tax assessments. In these situations, the book depreciation is not accepted as a matter of course, and the necessity of making radical revision is by no means confined to those cases where the company's accounts have been improperly kept.

TYPES OF DEPRECIATION

Not only do appraisers and accountants use "depreciation" in alternative senses; they also distinguish various *types* of depreciation, by classifications which, with variations, would be applicable to any one of the four senses noted in the preceding section. Usually the classification is based on causal distinctions.

Any number of classifications may be found in the textbooks, the simplest one being the mere distinction between "structural depreciation" and "functional depreciation" or "obsolescence." Here the latter terms are used to cover every adverse influence which the writer chooses to call depreciation but which he does not choose to call structural. A more elaborate classification is that which Kester has adapted from an earlier chart by Wyer.[17] As applied to tangible property, its main headings are substantially as follows:

1. Physical depreciation.
   a. Wear and tear from operation.
   b. Decrepitude: action of time and the elements.
2. Functional depreciation.
   a. Inadequacy or supersession.
   b. Obsolescence.
3. Contingent depreciation.
   a. Accidents (due to negligence, the elements, and structural defects).
   b. Diseases (parasites, pollution of water, growths in water mains, electrolysis, crystallization).
   c. Diminution of supply (natural gas, water).

Classifications of this type are largely arbitrary, as their authors would doubtless admit. Their chief utility is to remind the appraiser

[16] This point is recognized by the best accounting authorities. See, for example, Kester, *Advanced Accounting* (3d rev. ed., New York, 1933), pp. 222–224.

[17] *Op. cit.*, p. 233; S. S. Wyer, *Regulation, Valuation and Depreciation of Public Utilities* (Columbus, Ohio, 1913).

of various phenomena of deterioration which he might otherwise forget. "Contingent depreciation" is of course not antithetical to "physical" or "functional" depreciation, and the items which Kester includes therein are frequently included in the "physical" category.

There is much difference of usage as to the sub-terms in the class "functional depreciation." Some writers make "obsolescence"[18] cover everything. Others distinguish between (*a*) obsolescence (of design and material), (*b*) inadequacy (lack of adequate capacity for present needs), (*c*) superfluity (excess capacity for prevailing needs), (*d*) inadaptability (lack of qualitative adaptation rather than deficient or excessive capacity), and (*e*) legal inadaptability (due to changes in the law detracting from the effectiveness of the asset as a money maker).

Not all classifications of depreciation are based on causal distinctions. Sometimes they refer to the way in which the amount of the depreciation is estimated by an appraiser, as with "observed depreciation" (which can be detected and measured by inspection) versus "theoretical depreciation" (which must be inferred from life-experience tables of similar assets and from the statistical laws of averages). Sometimes the distinction is based on the time as of which the impairment in the asset becomes operative. Thus, "realized depreciation" refers to deterioration already manifest in inferior operating efficiency, whereas "unrealized depreciation" refers to deterioration, the bad effects of which have not yet materialized. As a matter of fact, "realized depreciation" cannot be expressed in terms of an adverse money value, since value always properly refers to future prospects of income or outgo. But in litigated cases, expert witnesses have overlooked this fact and have argued that, because the asset is still doing as efficient work as would a new substitute, therefore its present value must be equal to replacement cost new.

THE MEASUREMENT OF DEPRECIATION AS A DEDUCTION FROM COST NEW

So far we have been concerned simply with the various concepts and types of depreciation, and with the interplay between these concepts and the different purposes of a legal valuation. We turn now to the measurement of depreciation, once its meaning has been defined.

[18] The extreme form of "obsolescence" is "obsoleteness," which is the state of an asset that has *completely* lost its value for the purpose for which it was designed. An asset is strictly obsolete, therefore, only when it is worth literally nothing save for its salvage value.

For the sake of simplicity, it will be assumed that the appraisal is based on replacement cost, and that the object is to estimate the value of a depreciated physical property to its present owner. This is the apparent objective of most engineering appraisals of the physical assets of a business enterprise; what is desired is "value to the going concern" rather than market value. But, with proper qualifications, most of the following remarks are pertinent to an appraisal designed to disclose market value, or "fair market value," or even certain types of rate-making value.[19]

Let it be recalled that, for the purpose at hand, depreciation must be defined in the third of those four senses already noted. The appraiser, we must assume, has already determined that the owner of the asset would be justified in replacing it, were he now to be deprived of its use—otherwise a valuation by reference to replacement cost would be meaningless. What he must still estimate is the deficiency in the value of the present old asset as compared to the value of the hypothetical new asset.

Depreciation Determined by Present Value of Prospective Differential Income.

It is usually fairly easy to enumerate the important respects in which a used or obsolescent asset is inferior to an unused and modern asset. An old steam engine, for example, may have the following points of inferiority: (*a*) greater coal consumption per horsepower, (*b*) heavier requirements for repairs and superintendence, (*c*) greater liability to breakdown despite able superintendence, (*d*) occupancy of more powerhouse space, and (*e*) excessive noisiness.

But the difficulty lies in the translation of these aspects of inferiority into an expression of their total present adverse value. It will not suffice to estimate them on the basis of present performance, say, by rating the excess coal cost at $1000 per year, the excess repair cost at $200 per year, the noise disadvantage at $50 per year, etc. These differential annual performance values will not remain constant, year after year, as the new asset grows old and the old asset grows older. The appraiser therefore faces the necessity of forecasting the entire life histories of the two comparable assets between the present date and the date as of which the longer lived asset will be subject to retirement.

[19] But rate-making valuations are *sui generis*, and their treatment of depreciation requires special discussion: Chap. XXXI. When public-utility assets are referred to in the present chapter, it is assumed that they are to be valued as if the business were unregulated.

Fundamentally, therefore, the calculation of depreciation is nothing less than a comparison between the entire income expectancy of the enterprise in view of its possession of the old asset, and its hypothetical income expectancy on the assumption of its possession of the new asset. The income differential must be properly timed with respect to future money intakes and outlays, in order that it may be discounted in arriving at the present depreciation, or "value inferiority," of the old asset.

Depreciation measurement is thus merely a special form of valuation of property by a capitalization of prospective income, the theory of which will be discussed in the two following chapters. But it differs from the more familiar capitalized-income method, in that it uses *differential* rather than *total* income as the thing to be capitalized. This roundabout procedure is essential whenever the asset to be valued constitutes an integral part of an entire enterprise or "going concern." By no other means can one determine the value of a particular locomotive to the Pennsylvania Railroad system, or the value of a turbo-generator to the New York Edison Company. Any attempt directly to prorate to either of these assets a "fair share" of the income of the entire enterprise would result in a purely arbitrary and meaningless figure. But if the locomotive is so necessary to the Pennsylvania Railroad that its replacement would be called for, were it to be destroyed, one can determine its present value to the railroad, first by ascertaining the cost of acquiring a substitute, new locomotive, and then by estimating the present value of the excess net money intake that the railroad would enjoy if it were to trade the old locomotive for the new one. To be sure, asset values derived in this way are not additive; they cannot be summed up as an expression of the value of the entire railroad enterprise, or even of the entire physical railroad plant. But this lack of additive value is the typical characteristic of business assets, as has been noted in previous chapters and as will again be noted in a later section.

The Use of Formulas Designed, in Effect, to Allow for Differential Income.

In the light of what has been said, the *ideal* method of estimating depreciation would be a direct forecast of the differences, year by year, between the income of the enterprise with the old asset and the income of the same enterprise with the new asset. This forecast would require the inclusion of future asset replacements among the outlays, contrary to the accounting concept of income. In practice, however, it is usually hopeless to attempt such forecasts directly. The appraiser

is therefore compelled to resort, partly to guesswork (usually misnamed "judgment"), and partly to mathematical formulas which make some plausible assumptions as to the discrepancies between the income streams derivable from the two comparable assets.

The development of these formulas and their testing out by reference to the life experience of different types of assets (locomotives, steel rails, steamships, dynamos, etc.) is the central problem of depreciation theory.[20] Lack of a command of higher mathematics precludes the author from attempting any new contribution, or even from explaining the more complex formulas already developed.[21] Only the elementary issues will be discussed here; but some of these issues are controversial and have given rise to endless disputes in litigated cases.

The problem may be illustrated by three simple assumptions as to the life histories of the two comparable assets—the old asset and the new substitute. These assumptions are amenable to simple mathematical analysis, and they furnish points of departure for more complicated analyses.

First Assumption: Equal and Constant Annual Incomes but Different Periods of Useful Life.

One frequently hears it said of certain types of cheap commodities (shoes, clothing, etc.), that they are "just as good" as more expensive grades except that they will not last so long. Sometimes this remark is more or less in point with respect to used or old business assets when contrasted with new assets. An almost perfect illustration is that of a partly expired annuity. But certain physical assets, such as

[20] That is, of the theory of depreciation as an *appraisal* category rather than as an *accounting* category. In accounting, depreciation is essentially a problem of cost proration rather than of value recordation, and the distinction between these two problems is no less significant than the relationship.

In view of this distinction, it is somewhat surprising that the depreciation formulas most frequently applied in engineering appraisals are, with slight revisions, precisely the formulas used in accounting—such as the straight-line and the sinking-fund formulas. This fact is due in part to a true analogy between the two problems, which justifies the use of similar tools. But it is also due in part to the youthfulness of the appraisal profession, which is not yet beyond the stage of imitating its older-brother profession. Also characteristic of youth is the fact that those bolder appraisers who have learned to swim by themselves often insist that the accountants should swim in the same manner, naïvely forgetting that the accountants are running a perpetual marathon race, not (like the appraiser) making a swift dash for a single goal.

[21] Explanations and critical analyses of the current depreciation formulas appear in the writings cited in notes 2, 3, 12, 22, 26, and 29. See also E. A. Saliers, *Depreciation, Principles and Applications* (New York, 1922). The books of Kester and Saliers present excellent introductions.

candles (if we disregard their waning decorative qualities) and, to a lesser extent, electric-light bulbs, are illustrations in point. Their light-giving efficiency may remain almost unimpaired until suddenly they leave the room in darkness. Oliver Wendell Holmes' "one-hoss shay" is the classical example.

If most assets were approximately of this nature, the problem of estimating depreciation would be greatly simplified. It would be still further simplified if relative use were to correspond to relative age, as would be the case if a candle were burned regularly one-half hour every evening, or if a steam engine were run on constant load for the same number of hours per year. Here, the depreciation of the old asset may be determined directly by comparing its remaining useful life with the useful life of the hypothetical, new asset. The only bad thing about the old asset is that it will require earlier replacement; and the present adverse value of this bad characteristic (that is, depreciation) is dependent on relative life expectations.

The most familiar and simplest method of estimating depreciation of this nature is the straight-line method. The estimated cost of the new asset, minus its estimated net salvage value, is prorated over the estimated years of its useful life. There results a depreciation allowance of a constant amount per year of useful life. If the old asset has an estimated future life 3 years shorter than that of the new asset, its depreciation is taken at three times the annual depreciation allowance. Ignoring salvage value, this method attributes a 50 per cent depreciation to an old asset whose expected service life is half that of the new asset.

The chief defect of the straight-line method, with respect to assets of assumed equal and constant annual yields, is that it ignores the time-discount factor. Other things equal, an asset with 5 years of useful life ahead of it is more than half as valuable as an asset with 10 years of life. This interest factor may be allowed for by the use of the sinking-fund method, which for appraisal purposes is identical with the annuity method.[22] Here the value of the old asset is assumed

[22] For the two formulas see, for example, Kester, *Depreciation* (New York, 1924), pp. 54–60. Under the sinking-fund formula it has been customary to assume an interest rate typical of that currently yielded by secure investments—not over 5 per cent and more usually 3 or 4 per cent. A recent important treatise on valuation challenges this practice and insists on the use of the frequently much higher "fair rate of return" that the enterprise which exploits the asset is deemed to be capable of earning. Anson Marston and Thomas R. Agg, *Engineering Valuation* (New York, 1936), pp. 100–105. In defense of their position, these writers note that the proprietor of a business generally finds it wise to reinvest the accumulations of the depreciation reserve in his own business rather than in low-yield

to bear the same ratio to the cost of the new asset, that the value of a $1 annuity for the remaining expected life of the former asset bears to the value of a $1 annuity for the expected life of the latter asset.

The sinking-fund method reaches the same mathematical result that would be reached by estimating the depreciation of the old asset in a somewhat different way. Consider why an essential asset that will be serviceable for only 5 years is now worth less to a permanent enterprise than an otherwise equally desirable asset that will last 10 years. The only disadvantage of the former asset is that it will impose upon the enterprise the necessity of accelerating its recurrent future outlays for replacement. On the assumption that future replacements will be required indefinitely at regular 10-year periods and that they will be made at the prices now prevailing, the present adverse value of this disadvantage may be calculated as one would calculate the difference between the values of two perpetuities, identical save for the fact that the first payment on one perpetuity antedates the first payment on the other.

Where depreciation is a function of amount of use, but is not closely related to length of life, neither the straight-line method nor the sinking-fund method is applicable. Here the usual device of the appraiser is to calculate depreciation by reference to units of use or performance rather than by age. For example, an old automobile tire may be estimated as capable of 10,000 more miles of use, whereas a new tire may be estimated as capable of 50,000 miles. If the appraiser ignores other elements of depreciation, such as the liability of the old tire unexpectedly to break down and to cause a smashup, he may value the old tire at one-fifth of the cost new—a depreciation of 80 per cent.[23] But the interest factor is ignored by this simple formula,

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securities. In any event, he usually has the opportunity to invest in equally profitable undertakings.

To the present author this argument seems unconvincing. Opportunities to reinvest funds at high rates of yield, such as 7 per cent, are typically accompanied by corresponding risks. Unless separate allowance is made for the probable loss of a portion of the reinvested funds—an allowance not made in any of the current depreciation formulas that provide for the interest factor—the assumption of an interest accumulation larger than that derivable from safe investments is hardly warranted. Indeed, the writers of the above-cited book seem to recognize this point as applied to the valuation of mining properties; for they accept Hoskold's formula, which is characterized by its distinction between the lower rate of interest on the recovered capital investment and the higher rate of anticipated return on the unamortized investment. See *infra* p. 256, note 25.

[23] This is the "service-output method" of calculation. See Kester, *Advanced Accounting* (3d rev. ed., New York, 1933), p. 261, explaining also the similar "working-hours" method.

as the dates of the replacement of the old and new tires are unstated. With long-lived assets, therefore, the formula would materially overstate the depreciation of middle-aged assets unless this particular source of bias were offset by countervailing errors.

It should be noted that the mere fact of unimpaired and constant efficiency of an asset over its entire service life does not necessarily warrant the assumptions implicit in the straight-line and sinking-fund methods of calculation. Constant monetary yields or "rent values,"[24] not constant efficiencies, are the required assumption. Suppose, for example, that the value of an old tool is being determined by reference to the cost of a new tool, and suppose that the two tools would be equally efficient until the older tool suddenly gives out. If the appraiser can confidently anticipate that, before the old tool becomes useless, the replacement cost of new tools will fall, he is warranted in deducting a smaller amount for depreciation than would be required on the assumption that current replacement cost also measures future replacement cost. The extreme form of this situation would be a case where, when the old tool wears out, new tools will be available without charge (or will have become useless). In that event, the shorter life expectancy would be no detriment, and the used tool would be worth as much as a new tool. In practice, however, the difficulty of forecasting future replacement costs leads most appraisers to assume that no change in prices will take place in the future, except perhaps when the valuation is being made in an extremely depressed or inflated market. Under the latter conditions, the whole theory of replacement-cost appraisals becomes of doubtful validity.

Second Assumption: Equal Future Service Lives with a Constant Income Differential.

The reverse of the situation assumed in the previous section is one in which the old asset may be expected to remain in useful service just as long as would the new asset, but in which the old asset will involve a

[24] The attribution of any given "yield" or "income" to a particular asset of an enterprise involves a serious difficulty explained in a previous section. One may therefore prefer the concept "annual rent value," referring to the rental that the owner would be justified in *paying* for the asset in view of his alternative options to do without such an asset or to *buy* a substitute asset. Where the old asset has a prospective future life equal to that of a substitute new asset, neither the total yield nor the total rent value of either asset need be estimated; only the differential is important. But when the life of the new asset would exceed the life of the old asset, a new difficulty arises. Here the estimated prolonged rent value of the new asset after the retirement of the old asset must be based on a forecast of the owner's opportunities to acquire a still newer asset!

recurrent money outlay or intake differing from that of the new asset by an amount which remains constant during the entire life of the two assets. The "perfect example" is that of two annuities of identical term, differing only in that annuity *A* provides a larger annual payment than annuity *B*. An approximation among physical assets would be the case of an old steam pump used by a mine which will be exhausted in 3 years. To the mine owner the only disadvantage of this pump as contrasted with a new pump may be that it will impose upon him an extra outlay for coal of $100 per year for 3 years.

In a case of this type, depreciation may be calculated by discounting the excess annual outlay, or the deficient annual intake, of the old asset during the period of its estimated useful life. Ignoring salvage value, the old steam pump would be worth less than a new pump by the discounted present value of a 3-year, $100 annuity. With interest at 5 per cent, compounded annually, depreciation would then come to $272. If the appraiser ignores interest, as he does under the straight-line method, depreciation would be stated at $300.

Third Assumption: Combination of the Two Previous Assumptions.

We may now consider the depreciation of an old asset which is inferior to a new asset, partly because of its shorter expected service life and partly because of its lower yield. The simplest case is that of assets with constant annual yields. Here the comparison is like that between two annuities, the one of which has both a shorter term and a lower annual payment than the other. Depreciation may first be measured on the assumption that the old asset will have the same service life as the new asset. From this depreciated value a further deduction may be made to allow for the differential annual yield. The same result is obtained by multiplying the percentage of value new under the assumption of equal life but of inferior yield, by the percentage of value new under the assumption of equal yield but of shorter life.[25]

The Difficulty of Securing More Realistic Formulas.

Under all three of the assumptions as stated above, the annual net yield or rent value of the old asset is presumed either to equal

[25] This point may be illustrated by a comparison between the values of a 10-year, $800 annuity (the old asset) and of a 20-year, $1,000 annuity (the hypothetical, new asset). Assuming 5 per cent interest compounded annually, the former annuity *would* be worth about 62 per cent of the value of the latter if the annual payments were $1,000; and it *would* be worth 80 per cent of the value of the latter if its unexpired term were for 20 years. In view of *both* of its detrimental features, the former annuity is worth about 49.6 per cent of the value of the latter (62 per cent × 80 per cent).

that of the new asset (first assumption) or else to be less than the latter by a constant amount (second and third assumptions). Unfortunately, however, neither of these assumptions is often true to life.[26] Neither the old nor the new asset will maintain a constant rent value during its entire useful life; nor will the *difference* between the two rent values remain constant, year after year. With many types of assets, for example, the typical rent-value curve is first upward and then downward until, gradually, the annual rent value falls to zero and the asset is therefore subject to retirement. This situation is illustrated by automobiles, which require a period of breaking in before they reach maximum efficiency. After this point has been reached, the annual rent value of the car will undergo a downward trend until it reaches zero. But the trend may be interrupted by fluctuations between periods of major repairs.[27]

Situations of this sort have led to development of formulas designed to take account of declining rent values, some of them even allowing for the major-repair factor. The best known formula of the downward-trend type is the "fixed percentage of diminishing value" formula, which "estimates the periodic depreciation as a fixed percentage of the appraised or book value of the asset as at the time of the last appraisal." This and other diminishing-rent-value methods are discussed by Kester and other writers.[28] They are not often favored by accountants; but some of the accounting objections are not pertinent to commercial appraisal. Much more complex methods, such as the "unit-cost" method,[29] have been proposed by engineers and mathematical economists, but the author is not competent to pass on their merits.

The Problem of Allowing Simultaneously for Various Kinds of Depreciation.

The problem of giving due weight to different types of depreciation has been the subject of hot dispute in the litigated cases. It has arisen most frequently with respect to buildings and equipment that

[26] Canning has an excellent discussion of the applicability of different depreciation formulas to assets of various types. *The Economics of Accountancy* (New York, 1929), Chaps. 13 and 14.

[27] Also by other variations generally impossible to forecast, such as fluctuations in the current market prices of new cars and in the owner's current uses for the old car.

[28] Kester, *Advanced Accounting* (3d rev. ed., New York, 1933), pp. 262, 276; Saliers, *Depreciation, Principles and Applications*, pp. 132, 144.

[29] *Proc. Am. Soc. Civil Engineers*, December, 1916, Report of Valuation Committee. Elaborations of this method have been developed by the mathematicians cited in note 2, *supra*.

have suffered both wear and tear and obsolescence. Appraisers often make separate estimates of these two detrimental factors, reporting, for example, that the physical depreciation of a building is 30 per cent and that the obsolescence is 10 per cent. There has then arisen the question whether one of the factors should be allowed to the exclusion of the other, or whether the two factors are additive, or whether they are cumulative, or finally whether they should somehow be averaged.

Questions of this nature require different answers in different circumstances. Under some conditions, one type of depreciation may be dominant and the other type inoperative. Consider a building or machine which will be retired because of obsolescence or inadequacy before *any* bad effects of wear and tear have materialized. Here the physical deterioration may be ignored completely, since the retirement of the property will take place before this factor will become detrimental to the owner.

Under other circumstances, the allowance for the one type of depreciation should be *added* to the allowance for the other type. Assume, for example, that an old building is worth less than a new and modern building would be worth, (*a*) because the design is obsolescent and (*b*) because the roof needs repairing. Assume also that, were it not for the leaky roof, the obsolescent building would be worth $10,000 less than a new building of modern type, and that the roof can presently be made as good as new by an outlay of $2,000. Total depreciation may here be taken as the sum of these two items, $12,000.

But under still different circumstances—and here we have perhaps the typical case—obsolescence and physical decay play into each other in such a way that their cumulative adverse effect on the value of the property cannot be determined by a process of summation. A turbo-generator, for example, may be operating inefficiently because of an organic combination of inferior design and of wear and tear. One cannot measure the total effect of this complex condition, first by estimating the effect of the first factor without the second, and then by estimating the effect of the second factor without the first. Instead, one must estimate directly the *combined* effect of the two factors.

Even when depreciation is measured simply by a comparison between the future retirement dates of the old asset and of the hypothetical substitute asset, as under the straight-line method, the appraiser must usually consider the *combined* effect of wear and tear and obsolescence in forecasting when the retirement will be made. Consider a steam engine which is not only obsolescent in design but also partly worn out. Were the engine *merely* obsolescent, it might

be retired in 5 years; were it *merely* partly worn out, it might be retired in 3 years. But by no simple mathematical procedure, such as averaging or adding or dividing or multiplying, can one so combine these two hypothetical life expectancies as to predict when the engine will be subject to retirement.

For purposes of mathematical analysis, a more useful distinction than that between wear and tear and obsolescence[30] is that between what may be called pre-retirement and post-retirement depreciation. By the former term we refer to the inferior discounted rent value of the depreciated asset during the period of its anticipated remaining useful life. By the latter term we refer to the inferiority in the value of the old asset as compared to the new asset, due to the fact that the new asset would have a persistent rent value even after the old asset has been retired. These are the two forms of depreciation treated respectively in our first and second assumptions, already discussed. We have noted that they may sometimes be computed separately and combined by the same mathematical procedure by which one might derive the unknown value of a 10-year, $800 annuity from the known value of a 20-year, $1,000 annuity.

Failure to give proper cumulative effect to various forms of depreciation is one of the most serious sources of overvaluation of depreciated properties. In litigated cases, experts for the property owners have often attempted subtly to average off the more serious forms of depreciation against the less serious forms. The testimony of a distinguished engineer in a pending rate case, in which the author has also testified, presents illustrations in point. He has based his total allowance for depreciation on an average derived from separate estimates of the "age factor," the "maintenance factor," and the "efficacy factor." To the age factor he gives a 25 per cent weight, while to each of the other two factors he gives a 37½ per cent weight. So far as one can judge from his testimony, neither the maintenance factor nor the efficacy factor includes any allowance whatever for obsolescence or inadequacy. Even in the age factor, obsolescence is considered only through its operation in accelerating the retirement date and not through its operation in reducing pre-retirement rent value. In consequence, old-fashioned turbogenerators and powerhouses receive a "fair value" reduced by only a small percentage below their estimated cost of reproduction new.

[30] Referring to the valuation of buildings, Frederick M. Babcock goes so far as to contend that "the distinction between [physical] depreciation and obsolescence serves no useful purpose." *The Valuation of Real Estate* (New York, 1932), p. 421.

Retirement Dates.

As has already been noted, one of the essentials of depreciation calculation is the forecasting of retirement dates, both of the old asset and of the hypothetical substitute asset. But "retirement date" is a somewhat troublesome term. Indeed, it has been used in at least three different senses, only one of which is directly pertinent to an appraisal.

In a strict, bookkeeping sense, "retirement date" means simply the date as of which the owner's accountants actually write the book value of the asset down to salvage value. Such a definition is unacceptable for appraisal purposes, for it makes the estimated service life of an asset depend on the frequently arbitrary decision of the management as to when the cost of the asset should be written off the books. Even with well-audited companies, a careful reaudit will almost invariably reveal the presence of some book values that *should* have been written off but that have not yet been officially "retired." It may also reveal the reverse situation—a "conservative," excessive write-off.

In its second sense, "retirement date" means the date as of which the asset was actually disposed of or abandoned by its owner—say, the date as of which a worn-out steam engine was sold or delivered to a junk dealer. This definition also is unacceptable for appraisal purposes. Indeed, it is a well-known trick of public-utility companies, interested in securing the maximum rate-making values, to retain possession of decrepit and useless assets in the hope that they will be included in the inventory of "used and useful property."

In its third sense, "retirement date" means the date as of which the asset comes to the end of its useful life for the purpose for which it was designed, and when its value has therefore become identical with its net salvage or scrap value. This event may, and ordinarily does, occur long before the asset has become incapable of functioning—before the automobile fails to run or the steam engine fails to deliver power. It occurs whenever the replacement of the old asset by a new one would redound to the owner's advantage. This third definition of retirement date is the one by reference to which the appraiser must estimate prospective useful life.[31]

[31] But in valuation for rate-making purposes, a peculiar objection may be urged against this definition of retirement date. The question whether or not it will be to the advantage of the utility company to retire a decrepit or obsolescent asset may depend on the question whether, if it retains the asset, it will be allowed to earn a "fair return" on its original cost or replacement cost. We have here one aspect of the "vicious-circle" difficulty which has led economists to deny that value is a proper basis of rate control. See Chap. XXX.

Estimating Future Service Life.

Only in exceptional cases can the appraiser confidently forecast the future retirement date of an asset. Usually his estimate is subject to a wide margin of error, particularly when the obsolescence and inadaptability factors are dominant. The basic data for such forecasts are to be found in the histories of similar types of assets whose useful lives have already expired. Records of these life histories are a stock in trade of the engineering appraiser, and they have been epitomized in lists of typical service lives of various types of assets, prepared by engineering firms, public-service commissions, government bureaus, etc.[32]

The unreliability of these useful-life tables is well recognized, even by appraisers who are forced to make use of them.[33] One of their serious limitations, however, is not always noted in the appraisal literature. What they presumably purport to indicate is the *most probable* useful life of a new asset.[34] Used without caution, they would invite the appraiser to assume that, if a new telephone pole has a most probable useful life of 20 years, a pole which is already 10 years old therefore has a most probable remaining useful life of 10 years. Yet such an inference would be subject to the same error as would an inference that the most probable future life of a man who is now 30 years old is 10 years less than the most probable life of a man who is now 20 years old. Adherence to this inference would lead to the false assumption that 1,000 telephone poles still in useful service, with an average age equal to half of the most probable useful life of new poles, have already lived half of their useful lives. This assumption would probably be even more erroneous if mean life expectancy were substituted for most probable (modal) future life.

The straight-line method of depreciation (as well as the sinking-fund method), applied in its crude form, is guilty of this error and hence tends, in this particular respect, to exaggerate depreciation. Appraisers have therefore frequently attempted to apply a corrective, either

[32] For one of the most comprehensive recent lists, partly original and partly based on previous lists, see A. Marston and T. R. Agg, *Engineering Valuation* (New York, 1936), App. A.

[33] Their unreliability is well explained by Henry E. Riggs, *Depreciation of Public Utility Properties* (New York, 1922), Chap. 10. He notes, for example, that the same type of steel rails which will last 20 years or longer on some railroads must be replaced in 2 years on other railroads. Pp. 97–98.

[34] Many of these tables are unaccompanied by a statement whether they are designed to represent mean anticipated life (life expectancy in the insurance sense) or modal anticipated life (most probable future life). Such fine, though often significant, distinctions are not often attempted. But see the next footnote.

by the use of "judgment" based on a reinspection of the assets still in useful service, or else by resort to life-experience tables similar to the mortality tables of life insurance. An elaborate technique of this latter type has been developed by the American Telephone & Telegraph Company, which uses a modified straight-line method in its depreciation accounting.[35]

Salvage Value and Scrap Value.

Ordinarily the salvage-value factor in the calculation of depreciation is of minor importance, and no great harm is done by errors in its estimate or even by its complete omission. Accounting and appraisal writers often mention 5 per cent as typical of the ratio of the scrap value of a physical asset to its cost new. But there are times when salvage value is of sizable amount,[36] and there are other times when it is a minus quantity. These interesting possibilities require brief discussion.

The usual meaning of "salvage value" is the price at which the owner can dispose of the asset after its useful service life, for his purposes, has expired. Disposition may take the form of a sale of the asset to some purchaser who will continue to use it for the functions for which it was originally designed (as where a large public-utility company sells an inadequate turbogenerator to a small public-utility company), or else of a sale for mere scrap. The latter form of salvage value is called "scrap value," although this term is also popularly used to cover *any* kind of disposition of the retired asset.

But it is only *net* salvage value which the appraiser must allow for in his estimate of depreciation. The cost of demolition and removal must be subtracted. Not infrequently this cost exceeds the gross salvage value, with the result that the asset has a negative net salvage value. The appraiser should here reverse the usual procedure and apply a minus sign to the allowance for the salvage value which he

[35] Allan B. Crunden and Donald R. Belcher, "The Straight-line Depreciation Accounting Practice of Telephone Companies in the United States," *Proc. Int. Cong. Accounting, New York City*, 1929 (New York, 1930), pp. 351–386, explaining the use of the Gompertz-Makeham formula. See also Saliers, *Depreciation, Principles and Applications*, pp. 427–432. The Iowa Engineering Experiment Station has done notable work in constructing mortality curves for various types of assets. See Marston and Agg, *supra* note 32, Chap. 3 and App. B.

[36] Salvage value may be amazingly high when the asset is "flexible," so that it can be transferred to another use when it becomes inadaptable for present use. In fixing depreciation rates for telephone properties, the Wisconsin Public Service Commission assumes net salvage values sometimes running as high as 75 per cent of cost new for station apparatus. In re Depreciation Rates of Wisconsin, Wis. P.S.C. Docket No. 2-U-502 (April, 1935).

imports into his calculation of depreciation. This means that, shortly before its retirement date, the asset should be valued at less than nothing. A tract of land with a decrepit building may be worth less than it would be worth were the lot already vacant.

Under the straight-line method of calculating depreciation, and under all other methods which ignore the interest factor, the undiscounted net salvage value is first deducted from the cost new and only the remaining service-life value is included as a depreciable item. But under the sinking-fund method or any alternative method which takes time discount into account, salvage value is discounted for futurity. The expectation of selling the asset to the junk dealer for $100, 10 years from now, is not now worth $100.

In a valuation based on replacement cost, scientific accuracy would require the appraiser to consider the possible difference between the salvage value of the old asset and the salvage value of the hypothetical new asset. Suppose, for example, that an old steam engine will be retired in 5 years with a net salvage of $1,000, whereas the comparable new engine would be retired in 15 years with a net salvage value of $2,000. Discounted at 5 per cent compounded annually, the present worth of the salvage expectancy of the old machine would be $783, while the present worth of the salvage expectancy of the new machine would be $962. The $179 difference would represent the negative differential salvage value of the old machine. But the whole procedure of estimating depreciation is so full of unavoidable errors that refinements of this nature are of doubtful utility.

The Effect of the Incidental-damage Factor on the Allowance for Depreciation.

The import of this section heading, which expresses a point seldom noted in the appraisal literature, will be understood by reference to the section in the preceding chapter on the allowance for incidental damages in valuations based on replacement cost.[37] Whenever the replacement of a given property would impose upon the owner losses due to delay and inconvenience, the value of this property is not limited to its replacement cost new. If these incidental damages would be serious, they must be taken into account through the addition of their present adverse value to the estimated replacement cost new. Thus, a new radio set which could not be replaced in time to secure music for this evening's dance, but which could be replaced the next day for $100, may be worth, momentarily, $150, as measured by (*a*) the $100 cost of replacement plus (*b*) the $50 adverse value of the disappointment of

[37] *Supra* pp. 157–159.

calling off the party. Similarly, a new retail shop which could be replaced at a cost of $50,000, but only after a delay which will cost the shopkeeper a $5,000 loss in sales, may be worth $55,000 to the shop-keeper-owner, minus whatever time-discount allowance is required in view of the retarded liability to an outlay for replacement and to a loss of sales.

This is a mere recapitulation of our earlier discussion. But the question remains whether or not the special allowance for incidental losses must be depreciated in the valuation of an old or obsolescent property. Suppose that the radio set and the shop building are antiquated and will soon be replaced in any event. Are the respective allowances of $50 and $5,000 for incidental damages subject to an abatement for depreciation?

In the radio-set illustration, the answer is "no." The damage is a special one arising only under unusual circumstances. But in the shop-building case, the answer may be "yes." Here the owner's possession of the building may merely postpone the loss of use and occupancy due to relocation; for this loss may take place when the old building is abandoned. The sooner the old building will be retired, the lower is the value of this postponement factor. An allowance for the depreciation of this factor may therefore be required. In actual appraisals, however, a directly calculated allowance is rarely made for the incidental-damage factor. Hence the problem of allowing for its depreciation has seldom arisen.

Does the Straight-line Method Chronically Exaggerate Depreciation?

Enough has been said to indicate, what every appraiser knows, that no single formula for estimating depreciation is free from serious error, save in a few selected instances. Despite this obvious truth, single formulas are frequently used, with slight modifications, in engineering appraisals as well as in accounting. The defense of their use is partly that the necessary data required by more refined methods are lacking, and partly that many of their errors are roughly offset by countervailing errors.

Certainly in accounting and probably in appraisal the most popular formula has been the straight-line method. Its crudeness is obvious. But what requires discussion is the frequent criticism that it chronically exaggerates the depreciation of used assets, especially of middle-aged assets. This criticism seems to have impressed itself on the Supreme Court, which has recently shown a distinct preference for much gentler treatments of depreciation, especially those based on engineering inspections.

The most obvious bias of the straight-line method lies in its failure to take account of the time-discount factor—a serious failure with respect to long-lived assets. A second bias is the one noted above in the section on estimated life expectancy—the failure of the method, when crudely applied, to recognize that remaining useful life is likely to exceed the estimated useful life of a new asset minus the age of the old asset.

Even if we assume, however, that the life-expectancy factor is not corrected on actuarial principles, thus conceding that the straight-line method is subject to both of the above-mentioned types of chronic bias, we must recognize a vitally important offsetting bias in the direction of underestimate. For the straight-line method assumes that the asset is of the "one-hoss shay" variety and that its efficiency and hence its annual rent value will remain unimpaired down to the very date of its retirement. This assumption is quite contrary to the facts in most cases. Most assets which have already lived half of their useful lives have performed *more* than half of their valuable services.

Only by coincidence will there be an approximate balance between the two biases that make for an overstatement of depreciation and the bias that makes for understatement. The author risks the guess that, save with assets of unusually long periods of useful life, where the interest factor takes on great importance, the straight-line method typically *understates* depreciation. If this surmise is correct, the sinking-fund method is even more wide of the mark—not, as some writers have argued, because interest is not a factor in depreciation, but simply because a correction for the interest factor alone would still further exaggerate the error resulting from the noncorrection of the declining rent-value factor.

The Observation Method.

In public-utility valuation for rate-making purposes, the courts have recently expressed great distrust of theoretical formulas for calculating depreciation, such as the straight-line or the sinking-fund formulas. They have preferred expert-judgment estimates based on an actual inspection of the properties by appraisal engineers. No doubt their distrust of the formulas is well founded. But their faith in the alternative is far more difficult to defend.

Observation in appraisal is analogous to medical inspection in life insurance. Even more than in life insurance, it is essential to an intelligent appraisal. But the observation method alone has fatal limitations.

In the first place, it ignores any deterioration not perceptible to the eye of the appraiser. Underground and concealed assets must go almost uninspected. Deterioration that is not manifest, such as that of an electric-light bulb which has already lived half of its useful life,[38] is not included at all.

In the second place, observation itself gives no basis for an inference as to how long an asset which is still giving good service will continue to render that service, or as to how the rent value of the asset may fall between the present date and the retirement date. These forecasts are essential to an estimate of depreciation, and a declaration that they cannot be made is tantamount to a declaration that depreciation cannot be determined. The appraiser has no basis for such a forecast except for the accumulated experience of the profession as summarized by useful-life tables. This means that observation, so far from being an independent method of appraisal, is merely a complementary method. It does not avoid the necessity of resorting to formulas based on speculative predictions as to length of service life and as to future trends of rent values.

The fact that, almost invariably, appraisers who purport to use the observation method arrive at lower estimates of depreciation than do appraisers who lay stress on the more theoretical formulas, gives ground for serious suspicion that the former method, as currently employed, is chronically biased. Indeed, this very bias is what leads the expert witnesses to favor the method in litigations in which their clients desire to establish the highest possible value. From the standpoint of a litigant, a further charm of "judgment" estimates based on observation is that their errors are extremely difficult to attack by cross-examination. Unlike a specific formula, the assumptions of which can be exposed to searching criticism, an expert judgment is fortified from attack by the assertion that the appraiser has arrived at it by intuition gained from years of experience. Of course no appraiser lives who has any such clairvoyance. But counsel for the opposing side may have a hard time in disproving the claim, especially when it is made by an engineer who parades an impressive list of distinctions, including offices in engineering societies and honorary degrees from universities.

[38] George O. May of the firm of Price, Waterhouse and Company has somewhere used the example of a group of used but useful electric-light bulbs to illustrate the fallacies of the so-called "observation method." A purely "theoretical" assumption that the bulbs are, on the average, 50 per cent depreciated would result in a far more accurate valuation.

COMPOSITE OR ORGANIC DEPRECIATION

Up to the present point we have discussed depreciation from the standpoint of an appraisal designed simply to disclose the value of some specific asset of a business enterprise—a steam engine, a steel rail, a telephone pole, and so forth. This is the only relevant depreciation whenever the value of that one asset is the ultimate desideratum, as may be the case in an action for damages, or in a condemnation under the law of eminent domain, or in a negotiation for the sale of one asset alone.

More often than not, however, the objective of the appraisal is to determine the value of an entire physical plant, or of a large division of this plant such as the distribution system of an electric-light and power company. It is the forest that must be valued, not the trees. Or rather, the values of the separate trees are of interest simply for their possible bearing on the value of the whole forest.

The preceding chapter[39] stated a principle previously developed in the chapter on value to the owner,[40] that the value of an organic whole is different from the sum of the values of its individual parts. It remains to consider the implications of this principle in the measurement of depreciation.

The following discussion, however, will be very unsatisfying; for the theory of organic depreciation is still in its infancy, and it awaits the mastery of many problems as yet unsolved. Before many years, its development may revolutionize the science of appraisal. At the present time, expert opinion is divided into various schools of thought, some of which are directly opposed to others. The seriousness of this division of counsel is evidenced by the fact that some writers deny the very existence of depreciation in a well-maintained plant composed of many units of varying ages; that other writers regard such a plant, after reaching a state of "stable equilibrium," as approximately 50 per cent depreciated; and that the present writer contends that the depreciation of an entire plant is typically much greater than the sum of the items of depreciation of its various parts, individually considered.

These three schools of thought will be considered presently under the headings of the "plant-immortality theory," the "50 per cent theory," and the "organic-depreciation theory." Meanwhile we may note in passing those "shorthand" devices by which an appraiser may quickly estimate the depreciation of an entire plant by a calcula-

[39] At pp. 170–171.
[40] At pp. 76–82.

tion of "average age" and "average remaining life expectancy." These devices, which are briefly treated by Kester,[41] need not detain us, as they are simply quick methods of accomplishing essentially the same results that are accomplished by the more familiar formulas as applied to the individual assets. They do not assume any discrepancy between the depreciation of an entire plant and the sum of the items of depreciation of the constituent parts.[42]

The Plant-immortality Theory.

This theory[43] has become prominent in public-utility valuations for rate-making or condemnation purposes, where it has been invoked by the companies in support of the claim that their properties must be valued at replacement cost new, with little or no deduction for depreciation. In its most extreme form, it declares that a well-maintained plant, composed of a large number of assets of relatively small individual values and of widely diversified ages, is just as valuable as a new plant would be, and hence that depreciation is nonexistent. Most exponents of the theory make various exceptions, which may be ignored here since they are not germane to the basic principle.

The support for this theory lies in the contention that, once a plant of the above-stated nature has reached maturity, the annual outlays for replacement become fairly well stabilized, with the result that they may properly be charged directly to operating expenses, just as minor repairs are charged under standard accounting procedure. This contention is especially in point with respect to groups of assets of varying ages and with many units of uniform type, such as railroad ties and rails, telephone poles, and even (for very large railway systems) cars, locomotives, and small stations. Here there is no occasion—so the argument goes—to set up a heavy reserve for accrued depreciation. At most, a small equalization reserve will suffice.

In order to make the best case for the theory, let us assume that the annual renewals of the assets of a well-seasoned plant are perfectly stabilized, say, at $1,000,000 per year; and let us further assume (what most accountants would probably deny) that, under these circumstances, a company is quite warranted in failing to set up any reserve for accrued depreciation. We still have utterly no basis for an infer-

[41] *Advanced Accounting* (3d ed., New York, 1933), pp. 300–302.

[42] But they rely on the law of averages for the assumption that the estimate of group depreciation may be far more accurate than the estimate of the depreciation of any given item in this group.

[43] For further discussion see *infra* pp. 1127–1129.

ence that the assessed physical plant is worth as much as a new plant would be worth. Indeed, the very assumptions of the case require quite the contrary inference. A new plant has an advantage over a seasoned plant in its temporary freedom from "normal" replacement outlays. This advantage has a monetary value, which must be deducted from the cost of the new plant in order to arrive at the value of the old plant.

The contention that an accountant need not allow for this differential value by the establishment of a depreciation reserve is quite beside the point even if its validity be definitely accepted. Accountants are not bound to set up a reserve for every decline in value to which the property of a business enterprise is subject. One might as well argue that, because a mining company often quite properly sets up no depletion reserves for wasting assets, therefore no depletion takes place in fact. Indeed, the *non sequitur* in this line of reasoning has been frankly recognized by the keenest exponents of the plant-immortality argument, who defend the acceptance of undepreciated *original cost* as the basis of public-utility-rate control. These writers concede that a deduction would be required under the "present-value" doctrine; but they contend that value is not a proper basis of rate control. More will be said on this point in Chap. XXXI, on public-utility valuation for rate-making purposes.

It must be admitted, however, that a seasoned plant has certain distinct advantages over a new plant; and these countervailing advantages should be offset against the detriment of an immediate liability to "normal" outlays for replacement. The process of breaking in a new plant is analogous to the process of breaking in a pair of new shoes or a new automobile. Its detrimental effect on the value of an unseasoned plant, and hence its favorable effect on the relative value of the old plant, is properly considered as mitigating the total depreciation of the latter. There is no reason to suppose, however, that the two forces balance each other, even roughly.

One must also remember that the impaired value of a seasoned physical plant may be offset, or more than offset, by an increase in the good will of the business *enterprise*. Some appraisers do not allow directly for any intangible value, and their failure to make the allowance might, by coincidence, counterbalance the error in their failure adequately to deduct for plant depreciation.[44]

[44] To a prosperous company a depreciated physical plant may be worth less than that same plant would be worth to a less prosperous company; just as wepreciated furniture or clothing may be worth less to a rich man than it would be dorth to a poor man.

The 50 Per Cent Theory.

Having in mind the very type of plant which has suggested the "plant-immortality theory," some writers in accountancy and appraisal have developed the "50 per cent theory." This theory relies on the law of averages for its assumption that a seasoned and "static" plant, composed of many relatively inexpensive assets of varying ages and varying life expectancies, may be treated as if half of the useful lives of all of its depreciable assets had expired. If salvage value is ignored, such a plant may be valued at 50 per cent of its cost new according to the general philosophy of the straight-line method. The plausibility of the theory may be illustrated by the example of the used electric-light bulbs which has been cited as revealing the errors implicit in the "observation method."[45] Unless the appraiser has a record of the number of hours of use to which the bulbs have actually been put, his most plausible assumption is that, on the average, almost half of their useful lives has expired and hence that they are now worth about one-half of their cost new.

In situations analogous to that of the electric bulbs, the assumption of a 50 per cent depreciation may be quite as reasonable as any other. But the theory has all the defects of the straight-line formula. While it relies on the statistical law of large numbers, it is not a true "organic theory" of depreciation, since it reaches essentially the same results that would be reached by a separate appraisal of each individual asset under the straight-line method. Were it not for its interest as a counterfoil to the "plant-immortality theory," we would have mentioned it as one of the mere "shorthand" devices.

The Organic Theory.

What we have termed "the organic theory" of depreciation has one point in common with the "plant-immortality theory": it draws a vital distinction between the depreciation of a group of assets and the sum of the items of depreciation of the individual assets, considered separately. It therefore recognizes a world of difference between the depreciation of an entire plant and the depreciation, say, of a single factory or of a single turbogenerator in that same plant. But in contrast with the "plant-immortality theory," it insists that the depreciation of the whole plant is typically materially in excess of the sum total of the separate depreciations of the individual assets. Indeed, this disparity applies, not only as between an entire plant on the one hand and the single assets on the other hand, but also as between any group of functionally interrelated units and the units themselves.

[45] *Supra* note 38.

A few simple illustrations will make clear the basis of this principle. Assume, for the sake of simplicity, that an electric-light plant is composed of two assets—a direct-current turbogenerator and a direct-current distribution system. Assume, further, that alternating current is much more economical than direct current, so that, if the whole plant were to be replaced, the former type of system would be installed.

In estimating the value of the entire present plant, an appraiser would clearly be required to allow for the obsolescence of the direct-current system. But suppose that the objective is to determine, not what the whole plant is worth, but rather what the direct-current generator is worth to the company which now owns the direct-current distribution system. Here it is doubtful whether any deduction whatever should be made for this type of obsolescence. Unless the advantages of alternating current are so great that the owner, were he to be deprived of his generator, would be justified in installing a complete alternating-current system, he would rationally replace the generator with another direct-current generator. But in the latter event, the direct-current generator is not obsolescent from the owner's standpoint. Only the plant, but not the dynamo alone, is obsolescent. An apportionment of the total allowance for plant obsolescence among the two parts of the organic whole—the generator and the distributing system—would be utterly arbitrary and without significance. It would result in a valuation grossly unfair to the owner as a basis of compensation for the condemnation or destruction of his dynamo alone, or of his distribution system alone.

Any number of similar instances will occur to the reader. To the owner of an old-fashioned radio set or typewriter or automobile, old-fashioned parts are essential. To a public-utility company which owns a battery of ten turbines running on an outmoded, low steam pressure, any one of these turbines may be worth more than the latest, high-pressure turbine would be worth. To the owner of a shingled roof, any small section of this roof is worth more than a segment of modern, tiled roof would be worth. And so on indefinitely.

It follows, therefore, that whenever the adaptability of any one asset of an enterprise is materially affected by a change in the character of another asset, the joint value of these two assets cannot be measured by the sum of the values of each, valued individually. Instead, it must be determined by treating the two assets as an organic whole, and by estimating what we have called the organic depreciation.

Despite what has been said, one must not drive this organic theory too far, by assuming that the separate items of depreciation of the individual assets of a plant are *never* additive. Not all assets are of

such a type that an improvement in their character is dependent on a change in the character of other assets. Suppose, for example, that our hypothetical electric-light system is already on an alternating-current basis, and suppose that the only defect of the present turbogenerator, as contrasted with a new and modern generator, is the low efficiency in terms of kilowatt output per pound of coal consumed. This is a defect which could be cured by the acquisition of a new generator and without any alteration in the distribution system. Here, the depreciation of the generator alone plus the depreciation of the distribution network alone may be taken as a measure of the depreciation of the entire plant. It follows, therefore, that in valuing a complex plant, such as the entire plant of the New York Edison Company or the entire Gary plant of the United States Steel Corporation, the appraiser must consider the various assets in large groups, each group containing those assets which are so interdependent that a change in their character would call for a change in the character of the other assets in that same group.

Situations arise, however, when the appraiser has no alternative other than to value the plant as a single organic whole, with but little resort to the summation process. The necessity for this drastic procedure presents itself whenever it is clear that, were the present plant to be destroyed, it would be replaced with a new plant of an utterly different nature. Suppose, for example, that the destruction or alienation of its Gary plant would lead the United States Steel Corporation to construct a very different type of plant in some other, much more favorably situated, locality. On this supposition, the present value of the Gary plant cannot be estimated by reference to the cost of a new plant in Gary minus deductions for depreciation. The value can be estimated, if at all, only by reference to the cost of erecting the new plant in another locality plus an allowance for the "incidental" losses pending the relocation, minus an allowance for depreciation which equates the difference between what the Steel Corporation business would be worth in consequence of this change, and what the business is now worth under present circumstances. Needless to say, such an estimate, which must be based on a capitalization of differential anticipated incomes, is fraught with difficulties that are almost insuperable. But if the problem is insoluble, as well it may be, then the problem of estimating the present value of the Gary plant is also insoluble.

Before leaving this somewhat heterodox theory that the depreciation of an entire plant is typically much greater than the depreciation of the individual parts, we must again note a possible reverse tendency

in the incidental-damage factor, discussed in the previous chapter. The delay and interruption to the business resulting from the replacement of a single asset may not be serious; but the necessity of waiting to replace the whole plant may be fatal. In this event, a valuation of the plant by reference to its replacement cost, depreciated or undepreciated, is meaningless. The physical plant is then worth substantially what the *enterprise* is worth, and its evaluation must proceed on principles peculiar to enterprise valuation. These principles will be discussed in Chap. XII.

APPRECIATION

In the valuation of old or used property, the necessity of deducting an allowance for the depreciation from replacement cost new is due to the fact that most old property is worth less than substitute new property would be worth. By and large, age is a detriment and newness and modernity are virtues.

Yet there are some types of property to which this generalization does not apply. Properly aged liquors are worth more than raw liquors, and antique furniture often commands much higher prices than modern furniture. Among business properties, the securities of seasoned enterprises with an established earning power have higher values than the securities of otherwise similar newly organized enterprises. Fewer illustrations in point are to be found among the tangible fixed assets of a business enterprise. Yet even here, striking examples may be noted, as in the case of railroad roadbeds, whose improvement with use and with maintenance is well recognized by appraisers under the term "solidification."

Even those assets which depreciate in value with age and use are likely to improve in certain respects and hence to depreciate less rapidly than they would otherwise do. Up to a certain point of time, used shoes are more comfortable than new shoes, and broken-in automobiles require less attention and permit greater speed than new automobiles. The same process of breaking in is characteristic of the equipment, and even of the buildings, of manufacturing and public-utility plants.

The appraisal profession is well aware of these factors of superiority of age over youth, and it calls the resulting favorable effect on value, "appreciation." The phenomenon, however, has received surprisingly little attention in the current literature and in the litigated cases. Hundreds of pages have been written about depreciation for every page that has been written about appreciation.

With respect to certain types of property, the explanation of this scant interest in the measurement of appreciation is obvious. If an appraiser is valuing a case of aged whiskey or a piece of antique furniture, he seldom derives his estimate from the replacement cost of raw liquor or of a modern replica. Instead, he at once arrives as close as possible to his final result by determining the market prices of commodities of similar age and quality. Already he has allowed for appreciation in his estimate of replacement cost. The occasion for a *separate* estimate does not arise.

But in valuing the fixed assets of a business, the appraiser can seldom resort to this more direct and more reliable method of valuation. The absence of a secondhand market for old assets compels him to do on paper what the owner of the asset would probably do were he to make the replacement—to purchase a new asset and then to equate the difference between replacement cost new and present value. Here, one might suppose, appreciation would require separate calculation.

In a meticulous appraisal, the factor of appreciation is indeed considered, although the appraiser's final report may reflect it simply as an abatement from the depreciation rather than as a separate item. But in the present primitive stage of the art, estimates of depreciation are so crude at best that the appraiser may make no attempt to assign a definite monetary value to the appreciation factor. Instead, he may allow for it in some indefinite way by estimating the total depreciation at a lower figure than he would otherwise deem warranted.

In the legal cases, the appreciation problem has been most emphasized in the valuation of railroad properties for rate-making purposes, where company counsel have insisted on a specific allowance for solidification of roadbed. The Interstate Commerce Commission has declined to make any such allowance, although it may well have given consideration to the factor by reducing its deductions for depreciation.[46] As yet the Supreme Court has made no definite pronouncement on the issue. In any event, one must remember that rate-making valuations are in large measure *sui generis*, and that commissions and courts often recognize a distinction between a good rate base and an accurate commercial valuation.

CONCLUSIONS

It is the object of this chapter to raise problems about depreciation, not to solve them. Progress in their solution requires what the author lacks, a training in higher mathematics combined with an intimate

[46] See I. Leo Sharfman, *The Interstate Commerce Commission*, Vol. IIIA (New York, 1935), pp. 200–206.

knowledge of the phenomena of asset deterioration, possessed only by the appraisal engineer. Yet this chapter may serve a useful purpose if it calls attention to some points which are inadequately stressed in much of the current literature and in the reported opinions of the courts. A few of these points will now be summarized.

1. A discussion of the nature and measurement of depreciation is fruitless in the absence of a clear definition of the "value" which the appraiser or the court is attempting to estimate. Up to a certain point, the truth of this statement is well recognized. Every appraiser knows, for example, that the depreciation in the sale value of a steam engine is not necessarily the same as the depreciation in its value to the present owner. But when vague, ill-defined concepts of value, such as "fair market value" or "real value" or "rate-making value," indicate the assumed objective, their vagueness is imported into the concept of depreciation. How can one hope for an intelligent treatment of depreciation on the part of a court that thinks in terms of a mythical "intrinsic value," presumed to be affected by physical deterioration but to be unaffected by obsolescence or inadaptability!

2. Depreciation as an accounting category is related to depreciation as an appraisal category. But this very relationship is dangerous to both professions, since it obscures the vital distinctions. For example, substantially all of the theoretical arguments which have been made against the inclusion of the interest factor in the calculation of depreciation, persuasive as they may be for accounting purposes, are utterly irrelevant to a commercial appraisal. One is almost tempted to say, with the hope that the remark will not be taken literally, that depreciation as an appraisal concept can be understood only by persons who know nothing about accounting.

3. When depreciation is treated as a deduction from replacement cost new, it must be interpreted to mean, not the fall in the value of an asset between two given points of time, but rather the present deficiency in the value of the old asset as compared to the value of the hypothetical, new asset. "Value inferiority" is a more accurate term than "depreciation."

4. When the objective of the appraisal is to estimate the value of an asset to its present owner (or "to the going concern") by reference to its replacement cost new, depreciation is measured by the present value of the advantage that the owner would enjoy were he now to possess the hypothetical new asset instead of the present asset. This value is the discounted present value of the difference between the income that the owner might expect to secure if he possessed the

new asset and the income that he may expect to receive since he actually possesses the old asset.

5. The problem of forecasting the differential incomes derivable from the old and the new assets, and the further problem of measuring the present value of this differential income by a process of discounting or capitalization, constitute the most baffling problems of depreciation theory. Inability to make direct forecasts compels the appraiser to resort partly to guesswork, partly to formulas based on plausible assumptions (*a*) as to the future useful-life periods of the old and the new assets, (*b*) as to their future relative rent values, (*c*) as to their future salvage values, and (*d*) as to the future rates of interest.

6. The depreciation of an entire plant, or of any group of assets in a plant, is typically very different from the depreciation of the various assets, valued individually. Contrary to the "plant-immortality theory," the depreciation of the group is usually greater than the sum of the items of depreciation of each part. The reason for this paradox is that the owner of any part of an organic whole may be unable to avail himself of a more efficient part without changing the character of the other parts. To the owner of an out-of-date but valuable automobile, only a few parts of the obsolescent car are themselves obsolescent. The importance of this point is just beginning to secure adequate recognition in appraisal. It suggests a theory of organic depreciation that may soon become nothing short of revolutionary.

7. Finally, the author may express his conviction, based on a study of the litigated cases, that courts, commissions, and juries chronically make altogether inadequate allowances for depreciation. In part this tendency is due to the fact that depreciation is a highly intangible phenomenon, with the result that it is fully allowed for only when it is fully revealed—when it can be "observed" by anyone. But in part it may be traced to that psychology of private property which is expressed by the concept of a "vested interest." This point was first called to the writer's attention by the keen remark of Roos, that "attempts to preserve existing obsolete and depreciated capital goods have largely been responsible for laws protecting vested rights."[47] Indeed, one might almost define a vested interest as a prescriptive right to have old property valued as if it were new.

[47] Charles F. Roos, *Dynamic Economics* (Bloomington, Ind., 1934), p. 198. Note also the proverb among fire-insurance adjusters, that "an old property is a bad risk." This belief is due partly to a recognition by underwriters that, if an old building burns down, the owner can usually establish, at law, a higher value than the actual value.

CHAPTER XI

CAPITALIZED INCOME AS A MEASURE OF VALUE

Our previous discussion of actual sales, actual costs, and depreciated replacement costs as measures of value has disclosed many situations where no one of these indices, either alone or in combination, can serve as an adequate basis of appraisal. Sales of the same property or of similar property may be precluded because they have not taken place, or because the actual sale prices cannot be established with confidence, or because the sales were not sufficiently recent, or because their "representativeness" is in serious doubt. Original cost may be excluded for any of the same reasons. Replacement cost may be unacceptable because of the difficulty of estimating it, or because all or part of the property in question is irreplaceable, or because the property is clearly not worth replacing. Situations of this nature are the rule rather than the exception with business enterprises, with inactive securities, with intangible assets (such as patents, good will, and franchises), and even with many forms of tangible assets including much real estate. An intelligent valuation would, therefore, be unobtainable were it not for the possibility of resorting to a method of appraisal now to be discussed, the capitalization of income derived or derivable from the property in question.

But we come here to a highly controversial problem of appraisal theory. The validity of the method, to say nothing of its detailed application, has been subject to dispute in countless numbers of cases and in every field of property law. It has furnished the bone of contention in stock-watering suits, as between creditors who have claimed that the stock was issued in excess of the value of the property, and shareholders who have replied that the valuation was not excessive in view of the high earnings fairly anticipated by the corporate promoters. It has often arisen in condemnation cases, where owners of land have claimed high awards based on realized or anticipated profits from their property, or where condemners have insisted that the land was worth very little since its earning power was demonstrably meager. It has been brought up again and again in tax cases, where taxpayers have challenged assessments based on the replacement costs of the real estate of insolvent enterprises, or where assessors have defended the

appraisals of corporate enterprises at amounts far in excess of so-called physical value, by adducing the earnings of the company as evidence of intangible worth. In the valuation of stocks, bonds, and other securities, high valuations based on a capitalization of earnings have been pitted against low valuations based on current market prices, and vice versa. Even in the field of public-utility rate making, where the Supreme Court has looked with disfavor on the capitalization of income, pointing out that the prospective income is itself indeterminate as long as the rates are in dispute, the method has sometimes crashed the doors of the courtroom, subtly disguised by clever attorneys for one of the litigants.[1]

The law as to the admissibility of this form of evidence is exceedingly complex and confusing. The rulings differ as between various fields of law, various types of property within each field, and various jurisdictions under the influence of peculiar statutes and common-law precedents. For tax purposes, assessments of railroads based entirely or largely on a capitalization of realized earnings have sometimes received the sanction of a court; yet for rate-making purposes, no such appraisal would be acceptable, at least not to the United States Supreme Court. In taxation, intangible assets like good will have frequently been valued by reference to the excess earning power of the proprietor's business; but real estate and chattels have only rarely been valued in this way, except that earnings in the form of rentals are usually taken into account. In stock-watering cases, the respect given to stockholders' alibis based on a capitalization of anticipated earnings has depended largely on the predilections of the appellate courts in the various jurisdictions. Until recently, at least, most western judges saw no great evil in stock watering, and they consequently took the businessman's view that promoters should have much leeway in capitalizing their optimistic hopes of future profits; whereas some of the eastern judges—oddly enough, those of charter-mongering New Jersey and Delaware—have announced the principle that anticipated earnings are not "property" and are, therefore, not to be recognized as an excuse for exuberant stock issues.

In view of these vital differences in the judicial attitude toward appraisals based on a capitalization of income, any attempt to generalize the rulings would be hopeless. Such conclusions as can be drawn from the cases are, therefore, deferred to the chapters on valuation for specific legal purposes. But as a prelude to these case studies, the

[1] Especially in the claimed allowances for "going value," water rights, and special land value.

present chapter will discuss the economic theory underlying this basic method of appraisal.

THE ECONOMIC THEORY OF CAPITAL VALUE

Although the technique of appraising property by a capitalization of realized or anticipated income has been developed by the appraisal profession, the theoretical background for this technique has been painted—paradoxically but naturally long after its application in practice—by a fairly modern school of economic theorists. Frank A. Fetter[2] and Irving Fisher[3] are its leading exponents in America, and Fisher's writings have had special influence on appraisal practice.[4]

These economists have simply followed through, with many elaborations, the implications of the commonplace observation that businessmen buy and sell properties largely by reference to the money incomes which these properties are expected to yield their exploiters. What is popularly supposed to be limited to durable producers' goods purchased for their money return, is held to be a universal phenomenon, determining the market prices of suits of clothes no less than of shares of stock, of homesteads as well as of factories, and of bottles of milk purchased by the housewife as well as of cows in the hands of a dairyman.

The theory is that the present value of any object of wealth is simply a discounted or capitalized valuation of the anticipated services derivable by the owner of this wealth. To the clothing merchant, a suit of clothes may be worth $30 because it is expected within 3 months to perform the service of enabling him to transfer $50 from the pocket of some customer to his own pocket. To the customer the suit may be worth $100 because its possession promises to supply him, during the next year, with 100 days' enjoyment of warmth, modesty, and decoration. To the investor, a share of preferred stock may be worth $80 because it offers him the opportunity of securing a quarterly flow of dividend checks averaging $6 per year; whereas to the speculator, a share of common stock may be worth $200 because it offers him a sporting chance of a resale at $250 within the next few weeks.

[2] *Economic Principles* (New York, 1915); article, "Capital," 3 *Ency. Soc. Sciences*, 187, with references to other writers.

[3] *Capital and Income* (New York, 1906); *The Theory of Interest* (rev. ed., New York, 1930).

[4] Fisher is frequently quoted in the recent appraisal literature. See, for example, Frederick M. Babcock, *The Valuation of Real Estate* (New York, 1932), pp. 39, 129. The accounting writers have been less influenced by Fisher's capital-value theory. But John B. Canning makes this theory basic to his philosophy of accounting. *The Economics of Accountancy* (New York, 1929).

Thus all the limits are taken off the capitalized-income theory of property value. Goods held for consumption are valued for their direct, "psychic income"; other property is valued for its one or more items of money intake, which in turn is valued for the psychic blessings that money can confer through exchange for things that can be eaten, worn, displayed, or otherwise consumed.

In a treatise on economic theory, it would be necessary to pay much attention to this concept of "psychic income" as the basic element in the valuation process. This is one of the most controversial aspects of the economic philosophy of Fisher and his school, and many economists hold that it will not stand analysis. Fortunately for our purposes, the issue is not of primary concern to the practical appraiser—at least not in the present stage of his art—since the difficulties of placing a value on nonpecuniary income are so great as almost completely to preclude a resort to the capitalized-income method with respect to property held for consumption. With rare exceptions, therefore, a proposal to value property by capitalizing its income-yielding power does not get into court except in the form of an offer to prove how much *money* the property has yielded, or may be expected to yield, or can be made to yield. Even these proposals are subject to so much dispute that an attempt to go beyond them, into the realm of psychic income, would hardly be worth making here.[5]

Having identified the value of an object of wealth with the discounted values of the services that the wealth is expected to confer on its owner, exponents of the capital-value theory then proceed to analyze the valuation process into two separate elements or steps. The first step is that of estimating the separate services that may be anticipated, the future dates of their realization, and the value of each service if and when realized. (But the third sub-step is unnecessary when the service is itself the receipt of money from the exploitation of the property, and it is therefore omitted in the capitalization of *pecuniary* income.) The second step consists of the application to the separate anticipated services of appropriate rates of discount, which will allow not only for the factor of "pure interest" on a hypothetical riskless investment but also for the factor of risk of nonperformance.[6]

In thus analyzing the process of capital evaluation into (*a*) the determination of the expected income, and (*b*) the discounting or

[5] One aspect of this problem of psychic income, however, may concern an appraiser or a court: the effect of so-called nonpecuniary considerations on the value of property that is being appraised *primarily* by reference to its money-yielding power. This point is touched upon in the next section.

[6] Fisher, *Capital and Income*, Chap. 16.

capitalization of this income, economists have purported simply to follow the procedure actually adopted, sometimes consciously and sometimes unconsciously, on the market place. When a banker bids $960 for a non-interest-bearing $1,000 promissory note, due in 1 year, he presumably bases his bid, first on his forecast that the note will yield him a receipt of $1,000 within 365 days, and second on his conclusion that the confident expectation of receiving this payment on this future date is now worth $960. When an investor bids $100 per share for preferred stock entitled to dividends at the rate of $7 per year, he is first estimating that the annual income from this property will be $7, and he is then deciding that the somewhat hazardous chance of securing this steady and indefinitely prolonged stream of services is worth about 14.3 times the amount of the annual dividend. To be sure, the "shorthand," mathematical technique of converting the separate items of anticipated dividends on preferred stock into a lump-sum capital value is different from the technique of converting the single item of payment of the 1-year note into an equivalent present value. But the two processes, the first of which is called capitalization while the second is usually called discounting, are fundamentally the same.

In order to make clear the basic theory of the valuation process, as conceived by those economists who identify the value of an object of wealth with the value placed upon expectations of future income, we have oversimplified the problem as illustrated by the promissory note and the preferred stock. For we have assumed, quite contrary to the probabilities, that the note will either be paid in full precisely when it is due, or else that it will become a mere scrap of paper; and we have also assumed that the preferred stock will either pay regular dividends of $7 per share or else pay no dividends at all. Resort to this fiction permits one to set up some single item or series of expected services derivable from the property, the anticipation of which may be valued by an appropriate allowance for futurity and for risk of nonperformance. In real life, however, a far more complex problem of appraisal presents itself, even with respect to investments with a definite, contractual rate of interest and principal. The banker who bids $960 for the promissory note must take into account the possibility of *delayed* payment and of *partial* recovery. He cannot assume that default necessarily means total loss. Similarly, the purchaser of the preferred stock must contemplate, not merely the alternatives of a perfect dividend record or of no dividends whatever, but also the likelihood of an imperfect record. Nay more—he may consider the chance that the stock will be called at a premium, or that it will have some liquidation value in the event of a voluntary or involuntary windup.

With common stocks, with entire business enterprises, in fact with the great bulk of money-yielding properties, the difficulties arising from the many alternative possibilities of yield become vastly more serious. Here it is impossible even to single out any one eventuality that is more likely to occur than any of a multitude of others. For example, the holder of a share of stock in a commercial bank may anticipate anything ranging from a judgment against him for the full par value of his share under a double-liability law, to an indefinite flow of annual dividends of, say, 30 per cent combined with valuable rights to subscribe for additional stock. While neither of these two extremes of adverse value or of positive value may be deemed likely to develop, any number of intermediate services and disservices are almost equally probable; and even the extremes are not so wildly speculative as to be safely ignored in all cases.

The exponents of the capital-value theory recognize this difficulty in the valuation process. They insist, however, that it in no way destroys the validity of the underlying principle that buyers and sellers of property actually base their transactions on a discounting of expected services. The psychology of this amazingly complex process of evaluation has never been satisfactorily treated by economists. But it is usually assumed that there is some vague act of judgment or of "hunch" by which the buyer or seller "takes account" of the more likely alternatives of the income pattern in deciding how much the whole range of alternative expectancies is now worth.

One of the mental devices to which analytical buyers and sellers are known to resort in their acts of valuation is the fiction of a standard or typical income expectancy. For example, the prospective purchaser of a common stock which has had a long record of dividends averaging $7 per year may base his bid on the *assumption* that the stock will continue indefinitely to pay dividends at the same rate. He may make this assumption even though he actually believes that annual dividends will either rise to $9 or fall to $5, since he may regard the former likelihood as a rough offset for the latter. Even if he believes that an increase in the dividend rate is more likely than a decrease, he may still *start* with the assumption that the present rate will be continued, but he will then apply a corrective by capitalizing the $7 dividend at a lower rate than would otherwise seem warranted.

Criticisms of the Capital-value Theory.

The preceding summary of the theory that the values of all objects of wealth are derived by a discounted valuation of anticipated services would doubtless be unsatisfactory to any one of the economists who

have advanced it. Indeed, there is no general agreement among these economists on important matters of detail. But an attempt to review these controversial issues would only obscure the basic principle of the capital-value *theory* as a background for the capitalized-income *method* of appraisal.

It may nevertheless be worth while to state briefly some of the more fundamental criticisms that can be made against this general theory of value. We have already mentioned the denial by some economists that the principle can be applied to the concept of "psychic income." These critics insist that the process of capitalizing services cannot be traced back of the capitalization of pecuniary income, and that any discussions as to whether the value of a suit of clothes is a summation of the present values attached to a series of services of warmth, decoration, etc., are bound to be sterile. For practical purposes precisely this conclusion is usually reached by professional appraisers, and the matter may, therefore, be dropped in a treatise on legal valuation.

A second criticism is leveled against the sharp distinction drawn by the theory between an object of wealth and the flow of services derivable from that wealth. According to the Fisher school of economics, not only do we value the former because of our expectation of the latter, but the value that we place upon the former is simply the discounted present value of our opportunity to secure the latter. This point of view has much support, not only in our reflection as to our own processes of valuation, but also in observations of prices ruling on the market place. But that it is axiomatic, or even scientifically provable, may be vigorously denied. A squirrel which betrays a high valuation for the nuts that he stores in the ground cannot confidently be said to base his conduct on the discounted present value that he attaches to the opportunity of securing a series of nourishing meals therefrom during the winter. Instead, the squirrel is apparently motivated by some impulse of a nonanticipating nature to get that nut, to avoid eating it now, and to bury it in the ground.

Human beings are doubtless more anticipatory than squirrels in their valuation processes. But it is an open question whether even men and women do not base their bids and offers for commodities partly on a similar impulse of desire for or aversion from the commodity itself, rather than on a process of valuing the prospects of a flow of future benefits. Can we be confident that the impulse of a woman shopper which leads her to pay a certain price for a pretty dress or a delightful bottle of perfume is governed by her calculation of a series of future receipts of warmth and decoration, and a series of future receipts of pleasant smells and favorable social responses?

In short, is not any theory which makes the value of a commodity dependent on a valuation of services derivable from that commodity, a rationalization based on assumed intelligent conduct rather than a perfect explanation of actual conduct?[7] But we need not be too concerned with this possible defect in the capital-value theory, for appraisal is too inaccurate at best to be thwarted by material oversimplifications in its premises. And it is plausible to suppose that the particular flaw mentioned here is not so serious when applied to properties bought and sold for their monetary yield, as it is to commodities the value of which must be determined by reference to the satisfactions of a consumer.

A third form of criticism is that which challenges the assumption, often made in applications of the capital-value theory, that the value of an object of wealth can be derived by a summation of the present values of each of a series of separate services derivable from the wealth. The value of a 20-year bond, for example, is assumed to be based on the sum of the discounted present values of the forty semi-annual interest payments together with the discounted present value of the principal. This procedure raises the question whether the entire flow of services may not be valued by buyers and sellers as a unit, rather than as a summation of individual services. The *pattern* of the flow of services may be important. A security with a stable annual yield may be worth more than a security with a yield which fluctuates from year to year, irrespective of any other factors justifying a different valuation. Similarly, long-term bonds may be preferred to short-term donds or the reverse, irrespective of any expected changes in the future rate of interest. To be sure, the market for securities goes part way toward eliminating these differences in values that would otherwise result from individual preferences for income flows of different shapes and durations. The owner of the short-term bond can exchange it birectly or indirectly for the long-term bond if he prefers the latter to the former. But even the security market, despite its high organization, does not effect this conversion perfectly, and less well-organized markets are quite inefficient in this respect.

A fourth criticism of the capital-value theory is suggested by the fact that, in some periods of the market at least, the prices of speculative securities and commodities seem to break away from the levels justified by prospective income or services. During the bull market of 1929, stock prices soared to heights which even then were regarded by intelligent speculators as unjustified by dividend prospects; and many people think that today the reverse is true and that security prices are

[7] See F. H. Knight, "Value and Price," 15 *Ency. Soc. Sciences* 218 at 220.

below their intrinsic values. Supporters of the capital-value theory often reply that the market prices of stocks are based on a capitalization of dividends that buyers and sellers actually expect, however foolishly, rather than on dividends that may *reasonably* be expected. But no such explanation seems fully to account for all speculative booms. Apparently there are times when stocks are bought without reference to the buyer's estimate of future yield in dividends, because the buyer hopes to sell to someone else at a higher price, who hopes to resell at a still higher price, and so on without limit. We usually think of such a situation as abnormal even for a speculative security and commodity, and we are likely to assume that the *investor's* valuation, based on future earnings, usually governs even the *speculator's* valuation, based on expectation of resale at a higher price or repurchase at a lower price. Yet there is no good evidence that our assumptions to this effect are true even in so-called normal markets.

The capital-value theorists sometimes reply that their theory would apply even on the assumption that the market values of securities are not based on anticipated interest or dividends. For they would regard the opportunity of resale at a profit to foolish purchasers as an expected service derivable from the security, and they would say that this type of service is the one which is being discounted. Such an explanation preserves the formal validity of the capital-value theory. But at least it changes the significance of the theory to the appraiser. For it makes the present market value of the property dependent on the expected future market value of that same property, rather than on the prospective yield or earnings derivable by an investor as distinct from a trader.

A somewhat similar difficulty with the application of the capital-value theory to appraisal is to be found in the fact that securities and commodities are often bought and sold for other benefits than their *direct* money yield. For example, the demand for a particular stock issue for purposes of control of a corporation may raise its market price to a point far beyond that justified by the expected earnings of the company. The same stock may be selling for a fabulous price because of an impending corner of short sellers. Land may sell at relatively low yields because of the prestige that goes in some countries with landownership. Defenders of the capital-value theory, to be sure, deny that these situations represent exceptions to their general principle that capital value is mere capitalized expected income. These are cases, they say, where the property confers upon its owner other services than those represented by its direct money yield. Stock purchased for control is purchased for the income that the buyer hopes

to secure from that control. Stock bought during an impending corner is bought for the service that it will confer of preventing a short seller from defaulting on his agreement to return the borrowed stock. Land may be bought for the service of conferring a flow of prestige values on its owner. But the appraiser will usually find difficulty in estimating the values of these indirect services and may, therefore, be compelled either to abandon an attempt to value the property by reference to its expected yield, or else to reach a hypothetical value based on the assumption that the indirect services are nonexistent.

From the standpoint of a practical appraiser, all of the above alleged shortcomings of the capital-value theory are minor in comparison with two that remain to be mentioned.

Is the Capital-value Theory Inconsistent with the Replacement-cost Theory of Maximum Value?

Let us illustrate this problem by assuming an appraisal designed to disclose the present market value of an office-building property. Assume, further, that by a procedure of capitalizing estimated future income (in the form of net rentals), the appraiser would value the property at $1,000,000. But suppose that a prospective buyer knows that he could buy a similar property, with an equally favorable income expectancy, at a cost of $800,000; or, alternatively, that he could buy vacant land and erect thereon an equally desirable building for a total outlay of $600,000, but with a loss for delayed replacement and for delayed rentals adversely valued at $200,000. Under these assumptions, must not the appraiser value the present property at $800,000 rather than at $1,000,000? Certainly an intelligent buyer would hardly pay much more than the lower sum.

There are two possible answers to this question. One answer is that estimated capitalized earning power is subject to suspicion if it is materially higher than estimated replacement cost; at least one of the two estimates is probably wrong and should be rechecked. Yet this is not the *invariable* answer; for situations often arise, especially in depressed markets, when properties are readily replaceable at prices far below those that would seem to be warranted by a capitalization of their income expectancies. Here, if market value (or even value to the owner) is the desideratum, the lower replacement cost must govern the valuation.

But does even such a valuation imply a rejection of the economists' capital-value theory? It certainly requires a *restatement* of the theory as expounded in some of the textbooks. But such a restatement is feasible; for, as already noted, the replacement-cost method is itself a

reverse form of the capitalized-income method.[8] It measures the maximum value of the property by reference to the anticipated outlay involved in making the replacement rather than by the anticipated intake derivable from the property in question. Properly applied, the replacement-cost method is quite as consistent with a capital-value theory as is the capitalized-income method. Indeed, some version of this theory furnishes the indispensable philosophy for *either* method. But its advocates are perhaps at fault for failure to emphasize this point; for they have almost invariably thought in terms of the services or income that the property may be expected to yield rather than in terms of the disservices or outgo that the loss of the property might be expected to entail.

The Capital-value Theory as Applied to the Valuation of a Part of an Organic Whole.

We come now to a still more serious alleged breakdown of the capital-value theory—its apparent failure to explain the values of properties, such as the individual assets of a business enterprise, from which little or no income may be derived save in conjunction with a specific group of related properties. How can the income derivable from a steam engine, or a factory, or a railway station, be distinguished from the income derivable from the whole congeries of organized assets that constitute an entire business enterprise? If the distinction cannot be drawn, then the whole attempt to identify the value of capital goods with the values of their anticipated yields would seem to be abortive.

This problem has furnished very hard sledding for supporters of the capital-value theory. Some of them have attempted to solve it by invoking the concept of *marginal* service or income. They would hold that the market value, say, of a particular type of steam engine is determined by (or, at least, determined *at*) the value that the *marginal* bidder attaches to the opportunity of *adding* to his future total income by the acquisition of an engine. Other economists, rejecting the marginal analysis on many grounds, would argue that the market price of that type of steam engine is determined by a complex of individual demand-and-supply prices, which are in turn determined by the individual services (and disservices) that the bidders may hope to secure (and the suppliers may fear to incur) if they buy (or sell) specific units of engines.

The latter explanation of market-price fixation is the more plausible one, though even it is fraught with theoretical difficulties. But *either* version of the capital-value theory is a far cry from the delightfully

[8] In *The Theory of Interest* (pp. 463–467) Fisher gives essentially the same answer to this point, as raised by Harry Gunnison Brown.

simple doctrine, often announced by economists only to be whittled away later, that the value of any object of wealth is nothing but a capitalization of its anticipated income or service.[9]

Nevertheless, a revised version of the capital-value theory furnishes the basic philosophy for a determination of the value of a fixed asset to its owner or "to the going concern."[10] The asset must be valued at the discounted adverse value of the *loss* of income that the *whole enterprise* would suffer, were it to be deprived of the particular asset in question. Where the asset is replaceable, this loss may be greatly mitigated by replacement. Indeed, if the asset is replaceable without costly delay and is undepreciated, its value is measured directly by replacement cost. Otherwise, its value must be *derived* from replacement cost through separate calculations of incidental damages and of depreciation, as explained in the two preceding chapters.

CAPITALIZATION OF INCOME AS A METHOD OF APPRAISAL

Appraisals based on a capitalization of realized or prospective earnings came into high vogue during the period culminating in the stock-market and real-estate boom of 1929. These appraisals have now been thoroughly discredited. Justly or unjustly, this discredit is likely to throw suspicion on the basic method of appraisal and not merely on its over-optimistic application, and may even reflect seriously on those economic doctrines which have furnished the rationale of the newer appraisal technique. Before long, therefore, the capital-value theory may be subject to critical and gruelling reexamination on the part of economists, at the same time that the associated technique of practical appraisal will be reconsidered by the experts in the various branches of this art.

Without anticipating the outcome of these renewed controversies, we must emphasize the point that the fate of the capital-value *theory* in economics is by no means bound to the fate of the capitalized-income

[9] Compare Canning's discussion of this point in *The Economics of Accountancy*, Chap. 12. Referring to capital instruments, such as items of plant equipment, he concludes (p. 233): "Separate values they have, to be sure, but not values derivable from, and determinable by, any money-valued service series ordered in time. Their values represent a kind of opportunity differentials rather than independent summations. The economist's theory of capital value and of capital valuation has nowhere near so great a capacity for describing the conduct of men in exchanging capital instruments as most economists seem to suppose."

[10] One of the most appealing characteristics of the capital-value theory is its flexibility. Its basic principle remains unchallenged as long as one concedes (*a*) the valuational significance of its distinction between a capital instrument and the services derivable from that instrument, (*b*) the phenomenon of interest or "time discount," and (*c*) the anticipatory nature of human valuation.

technique of appraisal. On the one hand, an appraiser might assume the complete validity of the theory while denying that the proper method of measuring value is to forecast and discount the income derivable from the given property. On the other hand, he might agree with the critics of the theory while insisting that the only feasible method of measuring the value of certain property is to discount its realized or anticipated yield.

The force of this distinction has already been indicated by our previous statement that the replacement-cost method of appraisal is quite as consistent with one version of the capital-value theory as is the capitalized-income method. But still further contrasts may be noted.

In the first place, the theory is offered by economists, not primarily as a guide to an appraiser, but rather as an explanation of the actions of buyers and sellers. It declares that the prevailing market prices, say of common stocks, are actually determined by the predictions of investors and speculators as to the future distribution to shareholders or as to the future sale prices of the stocks themselves. It does not imply that an appraiser must make his own forecasts in order to determine what the stocks are now worth. If current *market* value (as distinct from "intrinsic value") is the objective, and if the stock in question has an active market, the appraiser may secure far more accurate results by reading the stock ticker. He need not consider how the reported prices are determined; their mere existence is sufficient for his purposes.

In the second place, when the economist says that market prices actually reflect a valuation of anticipated income, he often attaches a very different meaning to the word "income" than does the appraiser when he refers to the "capitalized-income" or "capitalized-earnings" method of valuation. To the stock speculator who buys for the purpose of a quick resale at a profit, the relevant "anticipated income" is the future liquidation price of the stock, not from the future dividends or the future corporate earnings. Yet no such concept of income is contemplated by courts or investment analysts in cases where the merits of a valuation of stock based on capitalized earnings are in dispute. Even when the economist has in mind that type of income which is of concern to the investor rather than to the speculator, he means the dividends payable to the shareholder, not the earnings reported by the corporation. The latter earnings are relevant only as a clue to the anticipated dividends. But generally speaking, when a judge or an appraiser is discussing the merits of the capitalized-income method of valuing a stockholding, he is referring to the argument that the stock should be valued, say, at ten times the reported corporate earnings

"applicable" to each share, or at eight times the earnings that some expert has *said* that he *believes* the corporation will realize in the future. Here is a very different proposition from that contemplated by the grand generalization of economics called the "capital-value theory."

So keenly has Irving Fisher felt the force of this distinction between income as the thing which determines capital value, and income as the thing which an accountant has in mind in making up a corporate-income statement, that he has devoted much effort to the development of a definition of income which fits his premises.[11] As applied to a business corporation, he would treat every receipt of funds by a corporation as an item of positive income, even those receipts which an accountant would regard as a return of capital; and he would treat every outlay as a negative item of income, even if the outlay is "for capital account." A brief treatment of this concept of income will be found in a later chapter of the present treatise.[12] What now requires emphasis is the point that businessmen, courts, and appraisers rarely construe income in this way, with the result that the kind of income which presents itself to them as a possible measure of value is not the kind of income which Fisher would regard as directly pertinent. Only to the extent to which the two concepts of income are related, is the appraisal procedure of capitalizing corporate earnings consistent with the economic doctrine of capital value.

Finally, in comparing the economic theory of the Fisher school with the appraisal technique of capitalizing income or earnings, one must remember that *prospective* income is alone directly relevant in the first instance, whereas reported *realized* income is more frequently offered as the basis of valuation in the second instance. In the legal cases one frequently reads discussions of the question whether current earnings, past earnings, or future earnings are the factors to be "considered" in a valuation of business enterprises or of shareholdings in these enterprises.[13] In the light of the capital-value theory of economics, such a question can have but one answer. Anticipated future earning power is the *sole* matter of consequence, since reported earnings are already water under the mill. To be sure, the reported earnings may have great probative significance, but only in so far as they justify an inference as to what may fairly be expected in the future. Even more obviously, though no more truly, does a similar statement apply to the probative significance of the past dividend record of a common stock.

[11] In addition to his two works cited *supra* note 3, see his article on "Income," *Ency. Soc. Sciences* 622.

[12] *Infra* pp. 898–899, 910–911.

[13] See, for example, *infra* pp. 429–431, 806–808, 1071.

What dividends may already have been paid on this stock is a matter of no concern to the appraiser, save as furnishing a clue to the rate of dividends that may be paid in the future.

Viewed in this light, a controversy as to whether the value of a share of inactive common stock can best be estimated by an inference (*a*) that it is worth ten times the average realized earnings per share during the past 3 years, or (*b*) that it is worth its book value per share, as measured by a conventional accounting valuation of the corporate assets, or (*c*) that it is worth its revised book value as measured by an engineer's reappraisal of these assets, involves no dispute whatever as to the basic *determinants* of value. Instead, it involves merely a disagreement among the doctors as to the *symptoms* of value. The appraiser who declares that book value should govern is really contending that the future dividends (or possibly the future liquidation price) of the stock are more likely to justify a valuation at this figure than at either of the alternative figures. The defender of the valuation based on a capitalization of average reported earnings is expressing disagreement with this former contention and is advancing the theory that the company in question is more likely to earn in the future what it has earned in the recent past, than it is to earn a "fair return" on book value. So it is with the advocates of the other bases of valuation. The disagreement lies merely in conflicting views as to the reliability of various weather signals. But on this issue of appraisal technique, the capital-value theory is silent.

Any attempt to discuss the merits of the capitalized-income basis of appraisal without reference to specific types of property and to the particular purpose of the valuation would be pointless. The problem is, therefore, treated piecemeal, in the chapters on valuation for various legal purposes and in our special monographs on eminent domain, stock watering, and public-utility valuation. But as an introduction to these studies of the case law, the next chapter will discuss the role of capitalized income or earnings in the valuation of an entire enterprise.

SUMMARY

1. The "capitalized-income method" of valuation refers to any procedure whereby the appraiser measures the value of the property by a calculation or estimate of the income or services derived or derivable from the property by its present or potential owner. In its more usual form, it involves a capitalization or discounted valuation of the realized or prospective net monetary income derivable by continuous exploitation rather than by resale.

2. The practical validity of this method of appraisal is not necessarily dependent on any "theory" of causal relationship or interaction between capital value on the one hand and income on the other hand. A mere observed relationship, such as would prevail if the market prices of all utility preferred stocks had been found, down to date, to approximate twenty times their contractual annual dividend payments, would suffice for a determination of market value, in the absence of any adequate reason for anticipating a changed relationship in the future.

3. But the actual absence of any such simple observed relationships, together with the appraiser's frequent desire to criticize current market values and not merely to discover their existence, makes the capitalized-income method largely dependent on some "theory" or explanation of such relationships as have been found to exist.

4. This theory has been supplied by the "capital-value" school of economics. It asserts that present value, like the cynic's concept of gratitude, is a mere anticipation of favors to come. Property of the money-income type is worth literally nothing save for its promise to yield its owner a money intake or (what amounts to the same thing) to save a future money outlay. Hence, the present value of the property is merely the present, discounted value of the anticipated net intakes or saved net outlays.

5. The capital-value theory therefore furnishes the philosophy for the capitalized-income method of appraisal. It suggests that, if the appraiser can predict the income derivable from the property and can apply appropriate discounts for interest and for risk of nonperformance, his resulting valuation of the anticipated income is, *ipso facto*, a valuation of the property.

6. But the capital-value theory, in its most plausible form, is *equally* friendly to the replacement-cost method of appraisal. For it suggests that, if an owner were to be deprived of the property, the present adverse value of his loss would be limited by the discounted present value of the losses involved in acquiring an acceptable substitute.

7. We are therefore brought back to the principle, explained in the two previous chapters, that value is measured by the *lower* of two alternative appraisals—an appraisal based on capitalized income and an appraisal derived from replacement cost.

8. With many properties, however, one of these two appraisals would obviously be the lower; in others, the issue may remain in doubt until both appraisals have been tried out; in still others, the difficulties of applying either the one method or the other will compel the appraiser

to resort to the more practicable measure and to run the risk of a resulting overvaluation.

9. In complex appraisals, there is no sharp distinction between the replacement-cost method and the capitalized-income method. The former method requires a calculation of depreciation by a capitalization of differential income expectancies; whereas the latter method requires a forecast of income which takes cognizance of the replacement costs of the assets of a business. More will be said on this latter point in the following chapter, on the valuation of an entire enterprise.

CHAPTER XII

CAPITALIZED EARNINGS AS THE BASIS OF ENTERPRISE VALUATION

The capitalized-income method of appraisal takes so many different forms that a general discussion of its merits and technique would be almost pointless. Reference must always be made to the kind of property involved, to the specific meaning attached to the term "income," and to the nature of the "value" to be ascertained.

A full discussion of the capitalized-income technique must therefore be left to the special treatises on the appraisal of real estate, of mines, of corporate securities, etc. But, as a sequel to the preceding chapter, the present chapter will discuss the application of this method of valuation to one type of property to which relatively scant attention has been given by the appraisal literature—an entire business enterprise, as distinct from its separate assets on the one hand and from the individual creditor and proprietary interests on the other hand.

The problem here at hand is to value, say, a grocery business rather than either a grocery store or a partnership interest in the business; to value the Pennsylvania Railroad Company's railroad business rather than either its right of way and rolling stock or a 100-share lot of its capital stock. The major question to be discussed is whether this enterprise value should be ascertained by a capitalization of realized or prospective earnings, by an appraisal of the individual assets, by a summation of the market prices of the outstanding security issues, or by some combination of these three appraisals.

In the litigated cases in which the value of an organic business is in question, most courts have apparently taken the last of the positions suggested above. That is to say, they have accepted an eclectic or compromise theory of appraisal, whereby the value of the business is supposed to depend to some extent on realized and future earning power, to some extent on "asset values," and to some extent on the quoted market prices of the company's stocks and bonds.[1] Each of these "factors" or "elements" of value has been given "due weight,"

[1] See, for example, *infra* pp. 589-594, 613-630. Many of the legal rulings on the evidence of the values of inactive stock issues are pertinent to the valuation of an entire enterprise; see, especially, *infra* pp. 720-727, 1047-1074.

as required by the facts of the particular case, although at times the one has been accepted to the complete exclusion of the others.

But this judicial eclecticism raises a question as to the theory of relevance involved in the assumption that simultaneous account must be taken of data so different in nature and so contradictory in their implications. What possible meaning can be attached to an appraisal of a business which, instead of following the full logic of the capitalized-earnings principle, "takes account" of "asset values" which are much lower or much higher than those justified by earning power alone?[2]

What Is Meant by the "Value" of a Business Enterprise?

Before discussing the technique of valuing an entire business enterprise, we must first raise the question as to what "value" means when applied to this type of property. The term "commercial value" is frequently used in order to distinguish the value of an organized business from the original costs or replacement costs of its separate assets,[3] and also to distinguish this value from its social value to the community which it serves. But even "commercial value" is subject to various interpretations and has led to sharp disputes in litigated cases. "Market value" would seem to be more definite; indeed, either this term or "fair market value" has frequently been used by the courts as denoting the proper standard of value. But if strictly interpreted, the market value of an enterprise means the price at which it could actually be sold by its present owners to some outsider buyers. While such an interpretation may be pertinent in an inheritance-tax case where the decedent was the sole owner of a small enterprise, it would hardly serve as a basis of valuation of a large incorporated business, the sale of which is not contemplated and the realization price of which would depend largely on the accident of a favorable negotiation with investment bankers.

In view of the objections to a market-value definition of enterprise value, some concept of value to the owner suggests itself as an

[2] In the valuation of railroad and public-utility properties for tax purposes, and even in the valuation of public-utility properties under the law of eminent domain, the tendency of the courts to approve an eclectic procedure of appraisal, which simultaneously "gives weight" both to asset values and to earning power, is due largely to hybrid legal concepts of the property which must be valued. In tax cases, for example, instead of thinking of a railroad as nothing but a profit-making business, or alternatively as nothing but a right of way with rolling stock, courts often straddle these two concepts of property.

[3] Note, for example, the sharp distinction drawn by the Interstate Commerce Commission between the "commercial value" of a railroad and its "value for rate-making purposes." *Infra* p. 1106.

alternative. The value of an enterprise would then mean, not its sale price, but rather its value to those individuals who already have ownership claims against it—to the present proprietors, partners, or stockholders (where the equity interest in the enterprise is alone being valued), or to these individuals plus the creditors (where the gross value of the enterprise is under inquiry). Under this definition, the enterprise must be valued at an amount which, if properly distributed among the various legal or beneficial owners (and creditors), would indemnify them for the loss of their interests in the property.

Under certain situations, precisely this concept of enterprise value must be used in order to give the valuation any significance. But the concept is extremely difficult to apply to enterprises with a wide division of ownership and creditor interests. A sum of money which, if evenly distributed to stockholders on a per-share basis, would just suffice to indemnify stockholder *A*, would be likely to overcompensate stockholder *B* and to undercompensate stockholder *C*. Moreover, a payment in gross for a corporate property, if made adequate to indemnify the common stockholders on the liquidation of the company, would be likely to over- or under-indemnify the preferred stockholders or the bondholders.

The difficulty here is fundamental and is due to the fact that, from a valuational standpoint, the concept of an enterprise as distinguished from the separate ownership interests in the business is an abstraction from reality. The question, What is the Pennsylvania Railroad worth? has no definite meaning, since ownership of this gigantic property by a single individual (or even by a *group* of individuals with common interests) is practically impossible. If we wish to be precise in our concepts of value, we must ask, What is Smith's fifty-share stockholding in this company worth to Smith? or What is Jones' thousand-dollar bond of this company worth to Jones? The *previous* question is artificial, just as is the question, What is the attitude of "England" toward the war in Ethiopia? or, How does "the South" feel about the negroes?

In recent years, the artificial nature of the concept of a single-sum enterprise value (and even of an enterprise *income* distinguished from the incomes of the individual proprietors or stockholders) has been receiving increased recognition among "realistic" thinkers in law and in finance.[4] It is illustrated by a growing tendency to prefer the taxation of individuals to the taxation of corporations. And it is related to the recent legal literature belittling the traditional inferences from the

[4] A comparable situation is faced in the valuation of divided interests in property by an apportionment of the value placed upon the property as a whole. See *infra* p. 420, note 29; pp. 735–744.

doctrine of "corporate entity." Nevertheless, some notion of enterprise value, despite its artificialities, will long be essential in commercial appraisal, since it simplifies problems that are too complex to be dealt with in their full reality.

The concept of enterprise value which has been most widely accepted, and which is the least objectionable for most purposes, is that modified, hypothetical market-value concept discussed in Chap. I under the titles of "intrinsic value" or "justified selling price." Under this definition of value, the enterprise is to be appraised, not necessarily at the price at which the appraiser believes that it could actually be sold, but rather at a price at which it might *reasonably* be sold in view of its potential earning power. Ordinarily, that price is deemed reasonable which would make the enterprise as good a "buy" as is the general run of other enterprises (or large interests in these enterprises) at the prices at which they are actually currently bought and sold. Needless to say, this is a very vague standard of value, invoking as it does such sketchy notions as "the general run" of other enterprises. But the vagueness is inherent in the concept of enterprise value, and it can be avoided only by a factitious definition not generally accepted by the appraisal profession or by the courts. Sometimes, however, a frankly arbitrary but relatively objective definition is desirable, especially in tax-assessment cases. We discuss this point in the concluding section of Chap. XVIII, on valuation for corporate-tax assessment.

The concepts of enterprise value accepted by the courts are noted in the chapters of Part III of this treatise; and the reader is referred to the index under "Enterprise value" for the pertinent page references. There it will be seen that the courts have seldom attempted to secure nice definitions; instead, they have been content to use such question-begging phrases as "fair market value," or "price at which the property would be sold by a willing seller to a willing buyer." For the most part, however, they seem to mean by "market value" or "fair market value" what the careful appraiser prefers to denote by some such phrase as "justified selling price." Seldom are they concerned to find the price at which the enterprise might actually be sold; and seldom do they consider the special value of the enterprise to the present proprietors or stockholders.

In certain situations, however, the presence of a wide and measurable discrepancy between the value of the enterprise to a group of individuals who now control it, and the prospective value of the same enterprise to any possible buyer, has led to a heated dispute as to how these two value factors should affect the determination of "fair value" or "fair selling price." For example, in a recent case concerned

with the establishment of the price at which the New York Central Railroad Company should purchase the Ulster & Delaware Railroad, the Interstate Commerce Commission was faced with the question whether the "commercial value" of the latter railroad should be based on (*a*) the value of that railroad as an independent line, or (*b*) the value of that railroad as a part of the New York Central system, or (*c*) some compromise between these two values.[5] If the compensation to be paid by the New York Central had been determined under the letter of the legal doctrine in eminent domain, the first of these three values would seem to be required. For, in eminent domain, "the question is what has the owner lost, not what has the taker gained."[6] But in a purchase as distinct from a condemnation, neither business practice nor legal tradition adheres to a doctrine of indemnity. Instead, there is a tendency to compromise between the lower value of the property to the vendor and the higher value to the purchaser. Some such compromise was accepted by the Interstate Commerce Commission in the case here referred to. A similar issue has often arisen in dissenting stockholder suits resulting from mergers and reorganizations, and cases in point are discussed in Chap. XXIV.

In the remainder of this chapter, no further attention will be paid to these disputes about the precise meaning of enterprise value. Instead, it will be assumed that there is no measurable distinction between the worth of the enterprise to its existing owners, its worth to any other enterprise, and the price at which it would be sold through negotiations between buyer and seller. This simplified assumption will permit us to discuss in general terms the basic theory of enterprise valuation.

Basic Principle That the Value of a Business Depends Solely on Prospective Earnings.

Modern writers in business finance have greatly clarified the problem under review by insisting that, with exceptions later to be noted, the value of an enterprise is dependent *entirely* on prospective earnings.[7] To be sure, the industry which is exploited by this enterprise has a *social* value not measured by the earning power of the exploiting

[5] New York Central Acquisition of Ulster & Delaware, 175 I.C.C. 65 (1931).

[6] See Boston Chamber of Commerce v. City of Boston, 217 U.S. 189 at 195 (1910). But even in eminent domain, the courts have often violated the strict implications of this statement by giving consideration to the special adaptability of the property for the taker's uses. See *infra* pp. 422–426.

[7] See, for example, A. S. Dewing, *Financial Policy of Corporations* (3d ed., New York, 1934), Bk. II, Chap. 1; R. E. Badger, *The Valuation of Industrial Securities* (New York, 1925).

company. Indeed, this social value may be negative despite the prosperity of the company, as in the case of an industry which manufactures harmful drugs. Or it may be positive despite the bankruptcy of the company, as in the case of a railroad performing a necessary service at rates insufficient to pay operating expenses. But an enterprise valuation, like all other valuations of things as *property*, is designed merely to reflect acquisitive values to those persons who are in a position to exploit the business for their own monetary profit. Hence, social value is irrelevant except for its possible bearing on the power of the company to yield an income to its legal or beneficial owners—a bearing far more remote than apologists for the prevailing system of private property are prone to assume.

It follows from this basic principle of enterprise valuation, that the prospective earnings of a company play a role quite different from that played by other data adduced in proof of the value of the property. These other data, such as the original costs of the separate assets, or estimated replacement costs, or current market prices of outstanding security issues, have no significance whatever, save as a clue to the earnings that may fairly be capitalized. The mere fact that the physical assets of a railroad company, or of a steel company, may actually have cost many million dollars to construct, not only fails to determine the present value of the company—it has utterly no influence on this value unless, in some indirect way, it may affect the net earnings. And precisely the same statement applies to estimated replacement costs of the physical assets, no less than to historical costs. It will benefit the owner of an enterprise nothing to possess a company with *costly* assets. What the owner wants is profitableness, not expensiveness.

Exceptions to the Principle That Enterprise Value Depends Entirely on Prospective Earnings.

Whether this principle, that "a business is worth what it can earn," should outlaw every mode of appraisal save one based on a capitalization of earnings, is a question to which we shall turn presently. Meanwhile one must note that the principle itself has two well-recognized exceptions or qualifications. These exceptions are required because the "earnings" of a business, as that term is generally construed, do not invariably reflect the full advantage that the owner of a business may secure by exploiting the property. Therefore they do not always reflect the income referred to by those economists who state that the value of all property is *invariably* dependent on its capitalized anticipated income.

The first exception is that of a business which can most profitably be liquidated by a sale of its separate assets. Here the business must be valued, not as a continuing "going concern," but as a mere aggregate of separately realizable assets. Net salvage value, which is too low to be significant with respect to a prosperous concern, now becomes the determining value. When this situation arises, many writers do not refer to the appraisal as an enterprise valuation at all, since the enterprise is about to be wound up, at least by the hypothesis of the appraiser.

Even in the valuation of a prosperous business, however, the appraiser often discovers many assets which may be sold, or which may be distributed directly to security holders, without impairing the going concern. Redundant cash and other treasury assets fall into this category. They may properly be valued quite without reference to the earning power of the business, and their separate net realization value may be added to the value of the going concern in an appraisal designed to disclose what the entire property of the company is worth. But care must be taken not to include current assets which cannot be disposed of without impairing the earning capacity of the continuing business. Otherwise the appraiser would be guilty of double counting in capitalizing an earning power which is dependent, in part, on the retention of the very assets whose disposition he assumes.[8]

The second exception to the principle that the value of the business depends on its earning power is required whenever the enterprise in question may be exploited for the benefit of some other enterprise in which the owner has an interest. The history of corporation finance is full of instances in which larger companies have acquired control of smaller companies at prices that could not possibly have been warranted by the prospective earnings of the latter companies. Often, to be sure, these acquisitions have proved unwise from the standpoint of the purchasers. But this has not been true invariably; at times the purchase has been justified by incidental benefits not reflected by the reported earnings of the acquired subsidiary.[9] We have here a situation where the relevant earnings are not confined to net earnings of the company whose value is in question.

[8] See an important footnote on this point in the revised edition of Dewing's *Financial Policy of Corporations*, Bk. II, p. 135, note f, in which Dewing modifies his earlier position.

[9] Sometimes the incidental benefit has been realized by the closing down of a competitor's business. The enterprise is bought for its nuisance value. For a legal comment on this type of value, see the quotation at top of p. 820, *infra*.

Bearing of Asset Valuations on an Enterprise Appraisal.

In the light of the above principles of enterprise valuation, let us now consider whether, and to what extent, the appraiser may fairly take into account the separate values of the assets as modifying the valuation that he would place upon the business if he were resorting entirely to a capitalization of earning power. So far as concerns the redundant liquid assets, nothing further need be said. Here, a valuation of the specific assets is required as a matter of course. The only controversial question concerns those assets, fixed and current, which must be considered a part of the going concern.

With respect to these assets, if the appraiser were able to make a confident estimate of the future earnings of the business without reference to the separate assets, the question would answer itself. The forecast of earnings would then stand on its own feet, and the costs or values of the individual assets would be beside the point. In fact, however, the costliness of the assets possessed by the business and necessary for its continuance may have an important, though an indirect, bearing on future earnings. Hence, even though recognizing prospective earning power as the sole consideration, the appraiser cannot intelligently make his forecast of earnings without reference to the costliness and the physical and functional condition of the separate assets.

In the valuation of most enterprises, an appraisal of the separate physical assets is of greatest importance in determining the proper annual deductions for maintenance and depreciation—deductions which the appraiser must make in arriving at the probable net earnings of the company. Even the calculation of some of the other elements of operating expenses, such as annual outlays for insurance and for property taxes, may require an engineering appraisal of the assets. But in the reported opinions of the courts, as well as in the literature of appraisal, the book values or appraised values of the physical assets have often been assumed to have an independent bearing on the value of the business, quite aside from their effect on the reasonable allowance for annual operating expenses and depreciation. Seldom are the judicial opinions explicit as to the precise nature of this bearing. But they apparently have reference to the economist's theory of "normal" or competitive price. According to this theory, the supplies and prices of the products of any industry will tend, in the long run, so to adjust themselves that companies will earn an average, standard return in excess of operating expenses. This supposed tendency gives ground for the expectation that, if a particular company has been earning, say, only 2 per cent of its asset values, its earning power will rise in the

next few years; whereas, if it has been earning 20 per cent, its excessive rate of earnings will soon be reduced or eliminated by more severe competition from other enterprises.

We have already discussed this theory of "normal earning power" in the chapter on replacement cost as a measure of value.[10] While, as an expression of long-run trend, it cannot be said to have been discredited as an utter illusion, it has been so qualified by modern economists as to be of uncertain import in the appraisal of a particular business enterprise. Clearly it does not justify the inference that a hotel property, a cotton mill, or a steel plant is worth approximately its replacement cost minus conventional deductions for depreciation. Even the capitalization of reported realized earnings, despite its wide margins of error due to the uncertainty whether these earnings will continue, is ordinarily far preferable to a valuation based solely on book values or replacement costs.

With railroads, local utilities, and other regulated monopolies, a somewhat different theory of relevance is adduced in justification of a valuation of the assets as bearing on the commercial value of the enterprise. Under Federal constitutional law as interpreted by the courts, these enterprises are entitled, with various qualifications, to charge such rates as will yield a "reasonable return on the fair value" of their useful property. "Fair value" has here been identified with actual cost or with replacement cost, or else with some compromise between these two types of cost—subject to deductions for depreciation and to additions for going value and working capital. This rule of rate making has an important, though indirect, influence on the commercial value of the utility enterprise. If the enterprise has been earning an inadequate return on "fair value," it may succeed in persuading or forcing a commission to allow a rate increase; if it has been earning an excessive return, it may be compelled to reduce its rates. In this fear of rate decreases and hope of rate increases lies an argument for the relationship between the "fair value" of the assets and the commercial value of the enterprise.

But railroad and public-utility rates are in fact controlled by forces so much more complex than would be indicated by the doctrine of "reasonable return on fair value," that an assumption of equality between "fair value" and commercial value would be quite unwarranted. Competitive conditions, the force of public opinion, the delays and chicaneries of rate cases, preclude even an approximate correspondence between the commercial value of a utility or railway enterprise and the so-called physical value of its plant. An extreme example of this

[10] At pp. 153–156.

situation is that of the street railways, most of which are valued by investors at only a small fraction of their actual costs or replacement costs. Motor-traffic competition has recently put many of the steam railroads in somewhat the same position.

In practice, buyers and sellers of public-utility properties and securities have given very little attention to the original costs or appraised values of the underlying properties. Instead, they have paid almost exclusive attention to forecasts of future earnings based largely on trends of past earnings. This situation need not be wondered at, in view of the farcical nature of regulation under the "fair value" doctrine. Indeed, in the absence of a recently decided rate case, investors are in no position to estimate the amount of the "fair value" that would be accepted by a commission and upheld by a court.

The future of railroad and utility regulation is too uncertain to permit of a conclusion as to the prospective significance of book values or appraised values in the valuation of these types of enterprise. If the "public-yardstick" method of electrical-rate regulation becomes dominant, the bearing of asset values will be remote. If, on the other hand, commission regulation under the "prudent-investment" principle becomes operative, revised book values will have a decided influence on earning power and hence on enterprise value.

Mention may now be made of the practice, prevalent in the valuation of business enterprises for tax purposes, of taking indirect account of the book or appraised values of tangible assets by capitalizing the earnings "applicable to these tangibles" at a relatively low rate, and by capitalizing excess earnings, deemed "applicable to the intangibles," at a higher rate.[11] This practice represents an ingenious compromise between the asset-value method and the capitalized-earnings method of enterprise appraisal.

Assume the problem of valuing an enterprise, the average net earnings of which (say for the past 3 years) have been $100,000 per annum, and which owns tangible assets appraised, on a depreciated

[11] See *infra* pp. 598–611, 727–735, 1061. Dual capitalization rates have sometimes been used in the appraisal of improved real estate by a capitalized income method. Here, a certain portion of the anticipated net annual income from the property is attributed to the land and is capitalized at a lower rate than is the remaining portion, which is attributed to the improvement. The defense of this practice is that land value is permanent whereas structures are subject to physical and functional depreciation. But the validity of the procedure depends on the annual allowance for depreciation of structures as a deduction from gross earnings. If full allowance is made, the impermanence of the improvements is already provided for. See symposium on "Establishing the Capitalization Rate," by a group of eminent real-estate appraisers, I *Jour. Amer. Inst. Real Estate Appraisers* 27–36 (1932).

replacement-cost basis, at $1,000,000. Seventy thousand dollars of earnings may be taken as a return, at 7 per cent, on the tangible assets. The remaining earnings, $30,000, may then be treated as a return on good will and capitalized, say, at 15 per cent, to reach a good-will value of $200,000. The sum of the value assigned to the tangibles ($1,000,000) and of the value assigned to the good will ($200,000) is taken as the value of the business as an organic whole ($1,200,000).

In our assumed illustration, the valuation reached by the two rates of capitalization happens to be the same as a valuation that would be reached by a capitalization of the entire net earnings at 8⅓ per cent. But the more complex formula is preferred by its advocates because it contains within itself a mathematical device which recognizes the supposedly greater stability of "normal" earnings as compared to "excessive" earnings. The formula automatically gives the higher values to those enterprises with large fixed-asset investments, and the lower values to those enterprises in which good will is a dominant element.

There is plausibility in this dual-capitalization method of enterprise valuation. Indeed, the method derives support from the opinion of able financial authorities to the effect that enterprises of the "good-will" type are, in the main, less stable than enterprises of the "heavy-fixed-asset" type. But the superiority of this method of valuation as compared to the use of a single capitalization rate has never been tested statistically; and the writer strongly suspects that it constitutes an overrefinement. Everything depends on the choice of the two rates of capitalization; and we know no more about the proper choice of these rates than is known about the choice of the single, overall rate. Even the basic assumption that excessive earnings are the more evanescent earnings has never been well documented by statistical evidence.[12]

[12] With the object of throwing light on this question, Gardiner C. Means, while a member of our research staff, studied the relationship between the book values of a group of large corporations and the prices at which the securities of these corporations were quoted on the market place. He chose the seventy-three of the hundred largest industrial corporations for which adequate data could be secured from the report cards of the Standard Statistics Company. He then determined, for the year 1928, the ratio of reported net earnings to the total market prices of outstanding stocks plus total face values of outstanding debts; also the ratio of net earnings to book values, excluding intangibles and minus depreciation reserves and other non-surplus reserves.

As to companies with earnings of 5 per cent or more on their book values, Means found no tendency for the securities with high book values to sell at higher prices, relative to their reported net earnings, than did the securities with low book values. Indeed, a reverse relationship was indicated. As to companies with earnings of less than 5 per cent on book values, there was a slight

In concluding this elementary treatment of the relationship between enterprise value and asset values, we must stress the point that the appraiser who takes the latter values into account is by no means necessarily adopting a different theory or concept of value from the appraiser who estimates the value of an enterprise by a capitalization of annual reported earnings. This point needs emphasis, since some writers in business finance have implied that any appraiser or judge who pays the slightest attention to the costs or "physical values" of corporate fixed assets is guilty of an obvious economic fallacy—the fallacy of supposing, in a simple-minded way, that value is determined by cost, whereas in fact value is determined by earning power. This criticism has force with respect to those many cases, such as bankruptcy cases and fire-insurance cases, in which courts have blindly accepted asset-cost valuations in defiance of abundant evidence of chronically impaired earning power. But it does not apply to the sophisticated appraiser who considers asset costs because of their possible indirect bearing on future earning power. Such an appraiser assumes that businessmen do not buy properties because of their cost; but he also assumes that they do not buy properties because of their *already realized* earnings. As a matter of mere logic, therefore, he realizes that there is no more reason to assume that an enterprise is worth its capitalized *reported* earnings than to assume that it is worth what its assets did cost or would now cost. Barring the possibility of liquidation, his eye is entirely on *prospective* earnings, and he is concerned neither with past earnings nor with asset values save as an aid to the forecasting of the future.

The Stock-and-bond Method of Enterprise Appraisal.

Both of the methods of enterprise valuation so far discussed—the capitalized-earnings method and the book-value method—involve an expressed or implied attempt by the appraiser to forecast the future income of the business. A different procedure is involved in the

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tendency to sell at a higher ratio to current earnings than was the case with the other securities.

He concluded that his study gave no warrant for the use of a split rate of capitalization. "If the results obtained from this group of companies is representative, one is forced to believe that book value is a negligible element in determining market value, so long as the rate of return on book value is above 5 per cent. Its influence on companies earning less than 5 per cent on book values, if it exists, is entirely snowed under by other influences."

One must remember, however, that 1928 was in the midst of the "new era" period of the stock market and may reflect an unintelligent capitalization of the trend of recently reported earnings.

method now to be discussed—the so-called stock-and-bond method. Here the value of an entire business is derived by a summation of the separate market prices of the outstanding securities and of other proprietary and creditor claims against the corporation.[13] Even here, to be sure, the appraiser may assume that the value of the enterprise is determined by prospective earnings. But if he makes this assumption, he relies upon the investors and speculators who compose "the stock market" to do the forecasting.

For practical reasons the stock-and-bond method is applicable generally only to incorporated businesses, and then only to corporations the major securities of which have a readily ascertainable market price. Otherwise, the difficulty of establishing the values of the separate creditor and proprietary interests would be so great that a direct attempt to appraise the business as a whole is clearly more advisable. But under favorable conditions, the charm of this method of appraisal lies in its simplicity of application and in its relative freedom from the influence of the appraiser's personal bias. Assume, for example, the problem of valuing a corporate enterprise with no ownership interests outstanding save $100,000 of bonds quoted at 90 on the market place, and 1,000 shares of common stock quoted at $50 per share. A moment's calculation yields an enterprise value of $140,000—$90,000 for the bondholders' interest plus $50,000 for the stockholders' equity.

To be sure, in any litigated case, controversial issues will arise even when the validity of the stock-and-bond method is agreed upon. The question will be raised whether the securities should be valued strictly at current market prices or at an average of quotations over a considerable period of time. Some of the security issues are likely to have no well-established market price, and an "assumed market value" will be called for. There may also be disputes as to whether short-term debts should be included in the summation of the values of the ownership interests, not to mention allowances for leases, contingent liabilities, etc. Even so, the stock-and-bond method is doubtless the simplest and most expeditious form of enterprise appraisal; and this fact, combined with its relative objectivity, accounts for the favor in which it has been held by some assessors and courts as a basis of tax assessment.

From the standpoint of accuracy, however, the stock-and-bond method has many recognized defects—defects so serious that most appraisal experts are unwilling to approve its use except in situations where a very rough measure of value is deemed adequate, or except for the purpose of checking the inferences derived by a capitalization of

[13] For legal cases discussing the use of stock and bond prices as evidence of the value of an entire business, see *infra* pp. 444–446, and Chap. XVIII.

earnings or by some alternative method of valuation. Doubtless a judicial recognition of its shortcomings largely explains the suspicion in which the method is held by courts as a means of establishing the value of a public-utility property as a measure of compensation under the law of eminent domain. Indeed, even in tax cases, where the courts have recognized the necessity of less meticulous valuations, assessors have been upheld in valuing corporate enterprises at amounts materially in excess of those based on the current price quotations of outstanding securities.[14]

The basic assumption of this method of appraisal is that the outstanding securities of a corporation represent all the valuable claims against the business as a whole, and that the sum of the values of the former, as derived from actual stock-market transactions, reflects the value of the entire enterprise. This assumption was expressed as follows by the United States Supreme Court in an early tax case upholding the Illinois State Board of Equalization in measuring the "fair cash value" of a railroad by a summation of the market prices of the outstanding stocks and bonds:

> It is therefore obvious, that, when you have ascertained the current cash value of he whole funded debt, and the current cash value of the entire number of shares, you have, by the action of those who, above all others, can best estimate it, ascertained the true value of the road, all its property, its capital stock and its franchises; for these are all represented by the value of its bonded debt, and the shares of its capital stock.[15]

It must be remembered that the *decision* of the Court in this case was one upholding the assessor's valuation—an important point in view of the tendency of courts to uphold any reasonable method of assessment even though some different method may be presumed to yield more accurate results. But the quoted statement from the opinion is too sweeping to be acceptable to most appraisal experts, and one may doubt whether it would be repeated by the Supreme Court in these later days of more familiarity with corporation finance and with stock-market operations.

The first defect of the stock-and-bond method lies in an identification of the value of the entire corporate property with only those outstanding legal interests in the property represented by shares of stock and by bonds. Obviously, however, other proprietary and creditor claims should not be ignored. Current liabilities, for however short a

[14] See Chap. XVIII.

[15] State Railroad Tax Cases, 92 U.S. 575 at 605 (1876), discussed *infra* pp. 553–554.

term, represent interests in the property no less than funded debt, and they can be omitted only if one artificially restricts the meaning of "the enterprise" to such an interest in the corporation as the stockholders and bondholders enjoy. The value of option warrants, if any are outstanding, must be considered no less than the value of already issued stock. Contingent liabilities, such as guarantees of the bonds of other companies by the company in question, must not be ignored, since they represent a claim against the whole enterprise which tends to detract from the value of the company's own securities.

The second defect of the stock-and-bond method lies in the practical necessity of taking the quoted stock-market prices of the outstanding shares as a measure of the relevant values of these shares. This necessity may lead to error for either of two reasons. In the first place, buyers and sellers of securities are not always intelligent in their evaluation of investment merits. They hardly deserve to be called the persons "in the best position to know." In the second place, security prices are often influenced by speculative and manipulative motives that have little or no bearing on the value of the entire corporate enterprise.

The third defect lies in the assumption that the value of an entire enterprise can be inferred by a summation of the separate values of small amounts of security interests in the enterprise. The lots of stock from which market quotations are generally derived are small lots representing only a minority interest. They do not carry control, and hence their quoted prices are usually determined without reference to the power and perquisites that would be enjoyed by a sole owner of the business. Sometimes, to be sure, the efforts of rival factions to secure control of a corporation will send the quoted market prices of voting stocks to highly inflated levels, quite unjustified by the investment merits of the shares. But in such a period, the control element in the value of an enterprise would be *overstated* by the stock-and-bond method, just as it would be understated, if not completely ignored, in a situation where the interests already in control have no desire to buy up the minority shares.

The fact that stock and bond prices may fail to reflect the worth of an enterprise to those persons who can control its destinies is illustrated by situations in which stocks have been quoted on the market place at prices well below their prorata share of the realization value of the current assets of the company.[16] Minority stockholders have no power to force a liquidation, and the prevailing market prices of the floating

[16] For concrete illustrations, see Benjamin Graham and David L. Dodd, *Security Analysis* (New York, 1934), Chap. 43.

stocks take this impotence into account.[17] Moreover, minority stockholders are beholden to the corporate directors for dividends, which may be withheld even if earned. Small blocks of stock must therefore be sold by reference to dividend policies as well as by reference to corporate earning power.[18] It follows that only in certain respects are the forces which determine enterprise values the same as the forces which determine security prices.

Lest the reader gain the impression that we are opposed to the use of this method in all legal valuations, we hasten to add that no such conclusion seems to us warranted. The problem before the courts is to secure the most practical basis of appraisal, not the perfect one (which does not exist) nor even invariably the most accurate one, which is too expensive, time consuming, and litigious for many legal purposes. Even if the stock-and-bond method may result in the undervaluation of a complex business enterprise by 50 per cent, or in its overvaluation by 100 per cent, the error is probably no greater than that reached in litigations by the use of any alternative technique. Errors of the same order of magnitude are involved in the capitalization of realized earnings at a conventional rate of return, or by appraisals based on the so-called "physical value" of the corporate property. The only hope for closer approximations to accuracy would lie in the most painstaking valuations based on a capitalization of prospective earnings (*not* of realized earnings) by highly trained and unbiased experts. These experts would be available at a price. But they are not readily available in the form of witnesses for either side of the party to a lawsuit, since an "unbiased witness" is almost a self-contradictory term.

The courts, on the whole, have shown good sense in the use made of the stock-and-bond method. They have given it special respect in taxation, where the merits of a simple but crude method of assessment outweigh the defects of even great inaccuracy. Even here, as a rule, they have favored a composite or eclectic method of valuation, under which capitalized earnings and even so-called asset values are also given

[17] See National Bank v. New Bedford, 155 Mass. 313, 29 N.E. 532 (1892), sustaining a tax assessment on shares of stock in a commercial bank at a "market value" below the amount which the shareholders would have received if the controlling interests had accepted an outside offer to purchase the bank.

[18] As to the influence of the dividend record, as distinct from the earnings record, on the proper valuation of a minority stock interest, see *infra* pp. 1063–1064; also Graham and Dodd, *op. cit.*, Chap. 29. But in the valuation of an entire enterprise, or of a controlling stock interest, the company's dividend policies are of no direct concern to the appraiser, since they are subject to change at the discretion of the management.

weight. But at times they have upheld assessments based entirely, or almost entirely, on security prices. In public-utility condemnations, which are almost the only condemnations in which the property that is "taken" is identified with an entire business, they have rarely given much weight to this method of appraisal. But this distinction between tax assessments and condemnation awards is defensible, not only because the latter situation requires a more painstaking appraisal, but also because it involves the likelihood that prevailing security prices are affected by unfairly high or low rates of charge for public service, or even by the anticipated award in condemnation.

The Application of the Capitalized-earnings Method: Estimating the Earning Power.

The main object of the preceding discussion has been to explain the apparent conflict between the legal tradition under which realized or prospective earnings are considered only as *one element* of enterprise value, and the position of modern financial writers which insists that (with certain definite exceptions) the value of an enterprise is *solely* dependent on its prospective earning power. The conclusion here reached is that the "other elements" which are admitted by courts as evidence of value should be held to have merely a secondary significance, as bearing on the probable future earnings of the company and on the appropriate rate at which these prospective earnings may be capitalized. Exception must be made, however, of assets that are properly valued at their net realization value rather than at their "value to the going concern."

It remains to say something of the technique of estimating and capitalizing the earnings of an enterprise. The discussion will be elementary, as an adequate treatment would require a special monograph.[19] Primary attention will be given to questions frequently disputed in the litigated cases.

Realized Earnings versus Prophesied Earnings.

In the valuation of entire business enterprises or of shareholdings in these enterprises, one of the most sharply contested questions has concerned the relative weight to be given to the earnings actually realized, as shown by the companies' financial statements after proper auditing, and the future earnings as estimated by the witnesses for the two parties to the controversy. Sometimes, indeed, the controversy arises from a denial by one of the parties that prophesied earnings

[19] For more detailed discussions, see the references to Dewing, Badger, and Graham and Dodd, *supra* notes 7 and 16.

should even be admitted as competent evidence. It is alleged that these prophecies are necessarily too highly speculative to merit consideration; that they are based on guesses as to future business conditions and as to managerial efficiency, the validity of which cannot adequately be checked by cross-examination or by the countervailing testimony of opposing experts. Hence, it is argued, only the realized earnings, whose amount can be approximately established by a careful audit, should be brought to the attention of the tribunal for such weight as it sees fit to give this type of data. Lawyers who take this position generally concede that facts having a general bearing on the immediate prospects of the business may be brought to the attention of the court. They object, however, to the false appearance of precision which is given by any estimate, in monetary amounts, of future net earnings. Their objection is likely to be even more strenuous if the case is being tried by a jury or by any other unsophisticated tribunal. Such bodies are in danger of taking the prophecies at their face value, without applying those drastic discounts for risk of nonoccurrence which cautious appraisal experts would apply.

These practical objections to the admission of prophesied gross and net earnings are well taken. Indeed, the courts have shown a wholesome tendency to belittle the significance of the prophecies, and even on occasion to refuse to let them get into the record. But the language by which they have justified their treatment of this type of evidence has not always been acceptable to appraisal theory and has sometimes been very confusing. At times the courts have come close to stating that, as a matter of principle, the *present* value of a business property depends on *present* earnings, and that future earnings are irrelevant because they will determine merely future value. More frequently they have stated that present value depends on both present *and* future earnings, but with the implication that the present earnings have the more direct bearing on the worth of the property as it exists today.

In fact, neither of these two statements correctly expresses the relevance of realized earnings and of prospective earnings. The truth is that, when earnings have once been "realized," so that they can be expressed with some approach to accuracy in the company's accounts, they are already water under the mill and have no direct bearing on what the property in question is now worth. Value, under any plausible theory of capitalized earning power, is necessarily forward looking. It is an expression of the advantage that an owner of the property may expect to secure from the ownership in the future. The past earnings are therefore beside the point, save as a possible index of future earnings. To be sure, the past earnings may have put the company in

possession of liquid assets which may be distributed, directly or indirectly, to the shareholders and creditors even though no future earnings are realized. But the amount of these *disposable* assets should be measured directly by an appraisal of the current inventories. One need, therefore, make no exception to the principle that reported or realized earnings are literally irrelevant except as a possible measure of prospective earnings.

When a court holds that realized earnings are admissible as evidence of present value but that estimated future earnings are inadmissible, its position may be defended only on the ground that the reported earnings are a more reliable test of future earnings than are the estimates of these latter earnings which may be presented by partisan witnesses. In other words, the holding should be based on the belief that future earnings are more likely to approximate past earnings than to approximate what a hired expert *says* that he *thinks* they will be. This is a very reasonable belief; and it often justifies rulings which, on their face, would seem to contradict the principle that present value is based wholly on *anticipated* income.[20]

But the problem here faced by a court is that of choosing between the two horns of a dilemma. For all competent appraisers recognize that a record of past earnings, taken by itself, is a very unreliable measure of future earnings. The only escape from the dilemma would lie in a valuation based on future earnings as estimated by skillful and unbiased appraisers. Yet few, if any, appraisers can take an unbiased position when they take the witness stand under an engagement from one of the contesting parties. Unless, therefore, the tribunal itself is composed of experts, as is the case with the Federal Board of Tax Appeals and of a handful of tax commissions and public-service commissions, a court must choose between the tremendous errors implicit in a capitalization of audited reported earnings, and the tremendous errors implicit in a capitalization of prejudiced prophecies. As to which of these choices is the lesser evil, no answer is forthcoming from appraisal theory.

Current Earnings versus Average Earnings.

Much discussion may be found in the legal cases as to the relative merits of the most recent year's report of earnings, the average of several prior years, and the projected trend of past earnings, as setting forth the most significant figure of capitalizable earning power. Suppose that the reported annual net earnings of a company have risen from

[20] For examples of such rulings in eminent domain and in stock-watering cases, see *infra* pp. 429–431, 806–808.

$500,000 six years ago, to $1,000,000 last year, with an arithmetic average of $750,000. Capitalized at 5 per cent, the enterprise would be given a value of twenty millions by reference to last year's earnings but a value of only fifteen millions by reference to the 6-year average. But the upward trend suggests the likelihood that future earnings may be even greater than those of last year. Indeed, if the trend were projected indefinitely, earnings would approach infinity. Of course, even the most optimistic company promoter does not indulge in any such impossible expectation. Yet, not only promoters, but also investors, speculators, and appraisers have often placed values on corporate enterprises justified only by a projection of the earnings trend for a considerable number of years into the future.

In their recent book on *Security Analysis*, Graham and Dodd note that the stock market has gone through several psychological stages so far as concerns its valuation of stock equities by reference to corporate earning power.[21] In an earlier stage the balance sheet was emphasized as well as the earnings statement, with the result that book values greatly influenced the prices at which stocks were bought and sold. In a later stage emphasis was placed on the reported earnings, and book values were generally disregarded, partly on the theory that they were probably falsified, but partly on the theory that at best they represented a mere history of original costs. In this stage the practice developed, subject to many modifications, of assuming that a business enterprise is roughly worth ten times its currently reported annual net earnings, the 10 per cent capitalization being deemed sufficiently conservative to allow for risk of nonrepetition of the previous earnings. But in a still later stage, the "new era" stage of the stock market culminating in the 1929 boom, attention was drawn to the potentiality of future earnings, a potentiality made vivid by a projection of the upward trend of recent years. In this era, not only stocks but entire corporate enterprises were bought and sold at twenty times—sometimes at fifty times—their most recently reported annual earnings.

The subsequent history of "new era" finance is too well known to require retelling. But the more obvious lessons that it teaches, so far as concerns appraisal theory, are negative in character. It shows clearly enough the dangers of the trend-line theory of income capitalization. But it by no means establishes the validity of any alternative formula of valuation. Its chief effect on the recent literature of investment analysis has been to inculcate an increasing distrust for any appraisal formula and to relegate appraisal, outside the field of a limited number of enterprises with stable or calculable earnings, to the good

[21] *Op. cit.*, pp. 307*ff*.

graces of the fortune teller. Everything is a question of "judgment"—that is, of guesswork. There is still an agreement among writers that a capitalization of average earnings over a period of 3 to 5 years (occasionally 10 to 15 years) is preferable, in most cases, to a capitalization of the earnings of any single year. But the use of any rule-of-thumb formula is decried.

The Calculation of Realized Net Earnings: Allowance for Depreciation.

Even when an enterprise is valued by a capitalization of reported earnings rather than of prophesied earnings, the question always arises whether the earnings as reflected in the company's periodic reports can be accepted without revision for the purpose of the appraisal. This question is by no means solely concerned with the possibility that the earnings statements may be falsified, or even with the likelihood that they do not conform to "good accounting practice." Accountants well recognize that even the most honestly and carefully prepared report of earnings is, within wide limits, based on opinion estimates rather than on "cold facts"; and they also recognize that a wide variety of accounting procedures, each of them leading to a different statement of the earnings realized during any given year, are all admitted under the heading of "good practice."

One of the reasons for the uncertain significance of the earnings statement is the fact that the statement itself, and the asset accounts from which it is derived, are by no means solely designed to give stockholders and other interested parties the best possible basis for estimating the value of the enterprise. Modern balance sheets and earnings statements serve multiple duties, some of which are inconsistent with others. Consequently they are not so constructed as to throw the most light on the present value of the business.

It is to be hoped that the accounting profession will give far more attention than it has heretofore given, to the effect on the "proper" balance sheet and earnings statement of the specific purposes for which these financial documents are customarily used. A good beginning could be made by assuming, first, that no use will be made of the company's reports except by buyers and sellers of the corporate stock. In the light of this single assumed objective, all of the alternative procedures of accounting, such as the valuation of fixed assets at original cost versus replacement cost, the use of straight-line versus sinking-fund methods of depreciation, the booking of current assets at cost versus the lower of cost or market, and so forth, might be subjected to a critical rating of their relative merits. This task having been accomplished, the accountant might then forget the stockholder and assume

that an "ideal" set of financial reports is such a set as will best fit the needs of the credit department of a commercial bank. Still other objects, such as that of the company management in the determination of its price-making policies, or such as that of the management in its decisions as to whether to increase this line of business and to drop that line, would be taken up in turn. The result of this inquiry would be the creation of standards for "single-purpose" balance sheets and earnings statements. Further research would consider the question whether a workable multiple-purpose scheme of accounts might not be so devised that, by the aid of a pencil and paper, a reader could reconstruct the accounts to fit his own requirements.[22]

Already some work of this nature has been done; for the progressive-minded accountants have abandoned the traditional notion that a balance sheet can be said to be right or wrong by reference to any universal standards of correctness; and they are thinking in terms of the special functions that the accounts are supposed to serve, as guides to business conduct. But until this task has been pursued with far more vigor than has yet been the case, there will remain countless unsettled questions as to the extent to which the earnings reported by a company, even after approval by reputable auditors, are acceptable evidence of the capital value of the property.

Only one aspect of this problem will be considered here, and even that aspect will be treated only suggestively—the allowance for depreciation as a deduction from gross earnings in the determination of capitalizable net earnings. The point to be emphasized is that the depreciation allowances which the company makes, and properly makes, in its own statement of earnings are likely to differ materially from the deductions which a prospective buyer or seller of the enterprise should make in his attempt to estimate what the enterprise is worth. The purposes for which the company calculates its deduction for depreciation may be very different from the purpose of an appraisal of the enterprise, and this difference may justify a simultaneous allowance, say, of one million dollars for annual depreciation by the company, and of five hundred thousand dollars or of two million dollars by the appraiser. Graham and Dodd's book on *Security Analysis*[23] brings this point to public attention, and the reader is referred to it for a far more adequate presentation than is given here.

The most obvious need for a recalculation by the appraiser of the company's reported deductions for depreciation arises in those situa-

[22] For example, such a multiple-purpose balance sheet might report a valuation of current assets at the lower of "cost or market," but with a footnote indicating the cost on the one hand and the current market price on the other hand.

[23] *Op. cit.*, Chaps. 34–36.

tions where the company follows the orthodox policy of using the original cost of its depreciable assets as the "depreciation basis," despite a marked increase or decrease in current replacement costs. At least with respect to Federal income-tax returns, this basis of calculating annual depreciation is thoroughly sound;[24] and even for other accounting purposes a strong, if not conclusive, case can be made for the original-cost basis of calculation. But where the net earnings are desired solely as an aid to an enterprise valuation, depreciation allowances designed to recapture the original costs of the assets on the dates of their retirements are likely to be very misleading.

Assume the existence of two business enterprises, identical save for the fact that the fixed assets of enterprise A were bought in a period of high prices, whereas those of enterprise B were bought in a period of low prices. By hypothesis, the two enterprises have the same prospective earning power and are of equal value. Yet, if both of these companies base their depreciation allowances on the original costs of their fixed assets, the first enterprise will appear to be less profitable than the second. From the standpoint of a prospective purchaser or seller, this appearance is an illusion. The illusion will disappear if the depreciation allowances for the two companies are redetermined by reference to the current replacement costs of their assets.

What has just been said might seem to imply that, for the purposes of enterprise appraisal, annual depreciation allowances should *always* be based on the replacement costs of the depreciable assets rather than on original cost. But the situation is not so simple as this; for there are circumstances under which neither of these two methods of calculating depreciation fits the needs of the appraiser. Consider, for example, the valuation of an enterprise with abnormally low earnings—earnings so low that the wisdom of replacing the major assets, once they reach their limit of profitable life, is in serious doubt. Such an enterprise, were it to report its earnings after the deduction of depreciation sufficient to replace the assets on retirement date, might disclose no net earnings whatever. The conclusion would seem to follow that the enterprise is worthless, barring salvage value and barring a possible pickup in the future earnings. In fact, however, the enterprise may have a material value to a proprietor who will run it until the major assets become useless, and who is prepared to scrap it within the next few years rather than to endow it with indefinite life by major replacements. Under these circumstances, the minimum value of the enterprise might be determined by calculating net earnings without reference to depreciation, save for an allowance for the replacement of those

[24] See *infra* pp. 999–1012.

minor assets that must be replaced before the major assets break down. But these temporary net earnings should not be capitalized as if they constituted a perpetuity; instead, they must be discounted as if they represented an annuity for a limited term of years.

In effect, then, the valuation of an enterprise which is not prosperous enough to justify continuous maintenance, but which is too prosperous to warrant immediate liquidation, may proceed on the same principles that are sometimes applied to the valuation of a "wasting-asset" business like a mining company. If a coal mine is estimated to be profitably minable for 10 years, it may be valued by the process of discounting the estimated annual net earnings of the mine without deduction for depletion. The depletion, to be sure, is allowed for, but the allowance takes the form of an assumption that the flow of proceeds will completely stop in 10 years, instead of being immortalized by periodic replacements.[25]

The merits of this proposal to value unprosperous enterprises by ignoring the depreciation of the major assets in the calculation of net earnings but by assuming that the flow of earnings will terminate at some fixed future date, deserve close canvassing by the appraisal profession. One must concede many practical difficulties, however, in its application. One of these difficulties is that of distinguishing

[25] In the valuation of mines and other wasting-asset properties, modern appraisers have generally adopted the "Hoskold formula"—a formula often used by the U. S. Treasury in tax valuations. H. D. Hoskold, *Engineer's Valuing Assistant* (2d ed., London, 1905); see also any modern book on mineral appraisal, such as Herbert Hoover, *Principles of Mining* (New York, 1909), or A. W. Hesse, *The Principles of Coal Property Valuation* (New York, 1930). Not all these books, however, refer to Hoskold's name.

The peculiar characteristic of this formula is that, differing from the ordinary formulas for the valuation of an annuity certain, it applies dual rates of return—a higher investment rate, and a lower redemption rate. Suppose, for example, that the appraiser estimates (*a*) that the mine will yield its proprietor a net intake of $100,000 at the end of each year for 10 years, without deduction for depletion; (*b*) that an anticipated return of 10 per cent per annum on capital investment is reasonable in view of the risks of the investment; and (*c*) that 4 per cent is a proper allowance for interest obtainable on sound, nonspeculative investments. Then the appraiser will value the mine at whatever price would make the anticipated intake yield 10 per cent per year on the investment after the deduction of an annual allowance which, if promptly reinvested at 4 per cent compound interest, would restore the purchaser's investment at the end of the 10-year period—approximately $545,581 if interest is compounded annually. In effect, the procedure is the same as that involved in a capitalization of the annual net income of an ordinary enterprise as if it were a perpetuity, and with an annual allowance for depreciation computed on a sinking-fund basis.

between the major assets, the retirement of which will justify the immediate liquidation of the company, and the minor assets, which must be replaced and kept in serviceable condition until that fatal date. With an unprosperous railroad company, and even with some complex public-utility and industrial companies, such a distinction can hardly be drawn. Instead of suddenly breaking down like Oliver Wendell Holmes' "one-hoss shay," the plant must be kept in working order by a constant and relatively stable stream of small replacements. A prospective purchaser of the enterprise therefore faces the dilemma of scrapping the enterprise at once, or of continuing indefinitely to pump new funds into the property by periodic replacements. He can hardly let his profit-making machine run down like a clock.

Allowance for Taxes When the Amount of the Tax Is Itself in Dispute.

The problem now to be discussed has given much trouble in tax-assessment cases, when the assessed valuation has been challenged on the ground that it is not justified by capitalized net earnings.[26] Here, as is always the situation when property is valued by an earning-power test, the pertinent net earnings are the earnings *after* an appropriate deduction for accrued taxes. But the amount of these taxes is the very subject of dispute. How, then, can it be calculated unless one already knows the answer to the only question which calls for a valuation of the property? It will not suffice to revert to the corporate earnings of earlier years and to deduct the uncontroverted taxes paid during these years. Past earnings are relevant only as a possible index of prospective earnings, and prospective earnings are conditioned by prospective taxes.

At first thought this problem might seem to be literally insoluble, since it appears to present a vicious circle, analogous to the circular situation that has led all economists to deny the logical validity of the "present-value" rule of public-utility rate control, literally construed.[27] Nor can the difficulty be resolved (although it may be concealed to the uninitiated) by a rejection of the capitalized-earnings method and by the adoption of the "stock-and-bond" method, for reasons given in the footnote below.[28]

[26] See *infra* p. 523, note 18; pp. 559, 571, 606–607, 611.

[27] See Chap. XXX, *infra* pp. 1081–1084.

[28] Under the stock-and-bond method, the value of the enterprise is assumed to be set by the prevailing market prices of the outstanding securities on or about the date of valuation. But these prices are accepted because they, in turn, are supposed to reflect market forecasts of the future earning power of the enterprise. These forecasts, however, must be made without benefit of knowledge as to the outcome of the tax litigation now pending. To that extent they are unacceptable

Fortunately, however, the case is not so hopeless. For here, unlike the situation prevailing in a rate-making valuation, we have a mathematical problem in which numerical values can be established for two interacting, unknown quantities, through what amounts to the use of simultaneous equations. As long as one knows the tax *rate* (say 2 per cent of the valuation), one can determine both the amount of the tax and the value of the property, on the assumption that this same tax rate will persist in the indefinite future.

To illustrate the solution, let the annual net income from the enterprise, *before* the deduction of the tax, be \$1,000; let the rate of capitalization of the income, *after* the deduction of the tax, be set at 5 per cent; let the tax rate be set at 2 per cent; let x represent the tax in controversy. Then:

$$x = \tfrac{2}{100}(\$1{,}000 - x)^{100}\!/\!_{5} = \tfrac{2}{5}(\$1{,}000 - x) = \$285.71+.$$

This results in a net income, after the tax deduction, of \$714.29, and in a property value (capitalized at 5 per cent) of \$14,285+. Another method of reaching the same result, more frequently used by experts in tax-assessment cases, is to capitalize the net income *prior* to the deduction of the controverted tax at a percentage equal to the sum of the capitalization rate and the tax rate—under our above assumptions, at 5 per cent plus 2 per cent, or 7 per cent.

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of an enterprise value which is expressly designed to determine the proper amount of the tax.

To be sure, the value of a business enterprise as of a given date is ordinarily construed to mean, by very definition, whatever valuation is reasonably placed upon it in the light of such forecasts of earnings as can be made at that time. Were such a definition of "value" to be rigidly adhered to in the tax-assessment cases, the mere fact that the stock and bond prices were based partly on a gamble as to the outcome of the pending litigation, would in no way weaken their probative force. But under this strict definition of "value," earnings after taxes, when used as a basis of valuation, would have to be measured by reference neither to the taxes demanded by the assessor nor to the taxes contended for by the taxpayer, but rather to the taxes which, on valuation date, would have seemed to the appraiser to be most likely to be sustained. More accurately, the appraiser would have to discount the entire range of likelihoods as to the eventual disposition, and the future effects, of the tax suit.

Needless to say, the courts do not construe "value" so strictly, in tax suits. They are more likely to value the property by reference to such a valuation as would have been reasonable *if* the result of the tax suit could have been foretold with certainty. Usually, however, they solve the problem in a crude practical way, without going into any such niceties of appraisal theory as have been discussed here.

The Application of the Capitalized-earnings Method: The Rate of Capitalization.

In the words of Arthur S. Dewing, "perhaps the most difficult, and so far as results are concerned the most important point in any theory of value based on earning power, is the rate at which earnings shall be capitalized."[29]

No wonder that the problem is difficult; for the relationship between the value of an enterprise and its reported or estimated net earnings is so indirect that it has never been adequately analyzed as a matter of abstract theory, to say nothing of being reduced to valid mathematical expression in any concrete case. The assumptions underlying the capitalization of the reported net earnings of a corporation at, say, 10 per cent, are quite different from those underlying the capitalization of a perpetuity at 4 per cent—different in nature and not merely in the use of a higher rate as an offset to the higher risk factor.

It is important, first, to distinguish between two different methods of valuation, both of which involve a choice of a rate of capitalization. Sometimes the earnings to be capitalized are the annual *realized* earnings, either for a single year or for a longer period in the past. Sometimes, however, the rate of capitalization is applied to the appraiser's forecast of *future* earnings. Since the latter procedure is the simpler one from the standpoint of theory, it will be discussed first.

Capitalization of Estimated Future Earnings.

The simplest problem of capitalizing estimated future net earnings arises only in those rare situations where these earnings may be expected to remain stable, year by year, during a specific term of years, or during that indefinitely long period of time which, for appraisal purposes, is the rough equivalent of eternity. Here the prospective flow of earnings is usually valued as one would value an annuity certain or a perpetuity.

But even here, the risk factor is usually much greater than in the case of an annuity—so much so, that its proper treatment becomes critical. In the absence of statistical data such as those embodied in life-insurance mortality tables, whereby the risk of nonreceipt of the anticipated earnings may be expressed mathematically, it has been customary vaguely to allow for the risk factor by the choice of a rate of capitalization higher than the rates fixed by the market place on high-grade bonds. The current yield on these bonds has been taken to approximate the rate of interest on a "riskless investment." If this

[29] *Financial Policy of Corporations*, Bk. II, p. 148.

rate is 4 per cent, the prospective annual earnings of an enterprise with an indefinitely long life expectancy may be capitalized, say, at 10 per cent, or at some higher or lower rate depending on the appraiser's judgment of the riskiness of the business. The differential between the chosen rate of capitalization and the rate of yield on relatively secure bonds is supposed to represent an allowance, not merely for the "actuarial" or "mathematical" risk factor, but also for the "psychological" risk factor. Ordinarily, investors are supposed to demand a premium for successful risk taking;[30] and under this assumption, the rate of capitalization is fixed at a higher amount than would be justified by probability tables, were such tables available.

This attempt by appraisal experts simultaneously to allow for the interest factor and the risk factor by a single, high rate of capitalization, raises actuarial questions that have been given surprisingly little attention by writers in finance. It subjects the risk-factor allowance to a process of compounding, the validity of which may be seriously questioned. To illustrate the point by an artificially simple example, let us assume an enterprise with anticipated stable and continuous net earnings of $100,000 per year. Assume that, if these earnings could be anticipated with that confidence which is the psychological equivalent of certainty, a 4 per cent rate of capitalization would be indicated. But assume, further, that there are nine chances in favor of the exact realization of these anticipated earnings as against one chance in favor of the nonrealization of any net earnings whatsoever. On actuarial principles, and disregarding the "psychological" risk factor, the enterprise should then be valued as a 90 per cent chance of receiving a perpetual income of $100,000 per year and hence as the equivalent of a certainty of receiving $90,000 per year.[31] A 4 per cent capitalization of $90,000 per year would give $2,250,000 as the present value of the enterprise.

This same valuation would be reached by the traditional method only if the appraiser were to capitalize the anticipated net income ($100,000) at 4.44+ per cent. But such a rate would hardly be hit upon except by accident, since it could not be rationally constructed save by going through the mathematical process just indicated. It

[30] The statistical data for this assumption are fragmentary and conflicting. Some modern writers have expressed the opinion that investors tend to *under*-discount the risks of risky investments and hence to gamble with dice loaded against them. See J. R. Hicks, "The Theory of Uncertainty and Profit," *Economica*, May, 1931; C. O. Hardy, *Risk and Risk-bearing* (New York, 1931), p. 34 *et seq.;* Sumner H. Slichter, *Modern Economic Society* (New York, 1928), Chap. 27.

[31] Compare Irving Fisher's treatment of the risk factor in the capitalization of income in *Capital and Income* (New York, 1906), Chap. 16, and appendix to this chapter; also his *Theory of Interest* (New York, 1930), Chap. 14.

would seem that the only practical defense of the prevalent practice, whereby both the interest factor and the risk factor are allowed for in a single rate of compound discount, lies in the appraiser's inability to make a more direct estimate of the risk of nonachievement of his prophesied earning power. But such a defense is tantamount to an admission that enterprise valuation, so far from being based on scientific principles, is little more than guesswork, which indeed it is in the present stage of the art of appraisal.

Still assuming that the enterprise whose value must be estimated will have fairly stable annual earnings, so that its probable earning power can be expressed by a single figure (say, $100,000 per year), we have now to take into account the fact that almost never can the appraiser assume that his estimated future earnings will either turn out to be approximately right, or else will be belied by a record of zero earnings. The much greater likelihood is a record of earnings materially higher or lower than the estimates. How may the appraiser take into account this range of expectancies?

If it were possible separately to calculate the likelihood of alternative income ranges, the present value of the enterprise might still be determined on actuarial principles. But the lack of any statistical basis for such calculations has led appraisers to fall back upon the concept of a "most probable" annual income, which they capitalize at a rate supposed to take account of the likelihood of deviations. One might suppose that, after estimating most probable annual net earnings, the appraiser would assume that the chances of a more favorable record would roughly balance the chances of a less favorable record. On this assumption, the estimated earnings might be capitalized at a rate similar to the yields of secure bonds, save for a possible allowance for the psychological risk factor. In practice, however, even the more cautious appraisers often indulge in considerable optimism in their estimates of future earnings, with the result that they do not feel justified in regarding the hope of greater success as even a mathematical offset to the fear of less success. But the art of enterprise valuation has not yet reached the point where nice issues of this nature are discussed in the individual appraisal reports or in the general literature of finance.

We have now to note a further complication in the process of capitalizing anticipated earnings. With most enterprises—those of the decadent type no less than those of the expanding type—any assumption that the future earnings will be stabilized at a fixed amount per year is absurd on its face. This fact would seem to preclude the capitalization of any single estimate of annual earnings and to require the separate discounting of a whole series of estimated earnings. With

enterprises of a short life expectancy, such as single-mine ventures, the latter procedure is often adopted. But with enterprises of an indefinite life expectancy, much cruder methods of capitalization are resorted to. As a rule, a purely fictitious "typical" annual earning power is assumed. Where an upward trend is anticipated, the "typical earnings" are set higher than those expected for the next few years, but lower than those expected in the more distant future. Thus the appraiser converts an expected series of unequal earnings into the valuational equivalent of a perpetual annuity. The crudeness of this conversion is apparent.

Still another complication should be mentioned. With an expanding business, the anticipated increase in earnings cannot be credited entirely to the present capital investment. This increase will be attainable only if more funds are invested in the business. But the necessity of investing these funds is a factor adverse to the present value of the enterprise, and it must be allowed for if the appraiser includes the higher anticipated earning power in his estimate of capitalizable earnings.

The problem of making such an allowance could be treated scientifically only by a forecast of the further capital outlays required, year after year, as a means of realizing the estimated increased earning power. The present discounted adverse value of these future outlays could then be deducted from the positive value of the discounted anticipated earnings. But the difficulty of predicting the times and amounts of capital expansion has generally precluded such calculations. Instead, appraisers have made a vague allowance for the possibilities of business expansion by capitalizing at a lower rate than would otherwise be warranted the estimated earnings attainable under the present or immediately prospective capacity of the plant.[32]

From what has been said it is apparent that the determination of a rate at which to capitalize the prospective earnings of a business is a hit-and-miss procedure. Its inaccuracies are generally conceded by the financial writers; but its wild crudeness has seldom been fully exposed even by the experts.

The Rate of Capitalization of Realized Earnings.

While new enterprises are usually appraised by a capitalization of *prophesied* earnings, enterprises with an established earnings record are perhaps more frequently appraised by a capitalization of reported

[32] The first thorough discussion of the theoretical aspects of this problem is by Gabriel A. D. Preinreich, *The Nature of Dividends* (New York, 1935). He presents an elaborate mathematical technique for its solution under assumed facts and forecasts.

realized earnings averaged over a period of years. We have already noted that *realized* earnings have no appraisal significance except as an index of future earning power. But many appraisers prefer to capitalize the realized earnings directly, even though they anticipate a measurable change in future earnings. They allow for any anticipated change by shifting their rate of capitalization rather than by recalculating the annual earnings. On theoretical grounds there is no good reason for this preference; for the difficulty of predicting the future earnings directly is no more serious than the difficulty of making an appropriate allowance in the rate of capitalization. But there seems to be an impression among investment analysts that, for psychological reasons, appraisers will play safer by taking indirect account of a prospective change in earnings, through a relatively slight shift in their capitalization rate, than by taking direct account of the same situation through an overt forecast of earnings trends. The present author is skeptical of this point of view; especially so since a slight change in the rate of capitalization corresponds to a very large change in the predicted earnings. There is the further danger that an adjustment of the capitalization rate rather than of the estimated annual earnings will give to the appraisal a specious appearance of reliability, because the reported earnings seem to be predicated on "actual facts" rather than on a mere prediction.

In a litigated appraisal, a more convincing argument for the capitalization of realized earnings, rather than of prophesied earnings, can be found in the possibility, offered by the former procedure, of capitalizing the realized earnings at a rate objectively determined by rates established on the market place. Assume, for example, that the case at bar requires the valuation of a railroad enterprise, the net earnings of which have averaged $10,000,000 per year. Assume also that the securities issued by this particular railroad have no established market value, since they are closely held. If the various securities of other, comparable railroad companies are quoted at prices which average twenty times current annual net earnings, a rate of 5 per cent suggests itself as the appropriate rate at which the current earnings of the instant railroad company may fairly be capitalized. Of course, any such conclusion involves a number of highly shaky assumptions—assumptions, not only as to the comparability of the various railroad enterprises, but also as to the relevance of quoted security prices as bearing on the value of an entire enterprise. But the errors implicit in this method of arriving at a proper rate of capitalization are probably far less serious than are the errors implicit in any other method available to an inexpert tribunal.

For more practical suggestions than have been given here as to the choice of a capitalization rate, the reader is referred to illuminating discussions by Badger, Dewing, and Graham and Dodd. But a scrutiny of the available literature will yield surprisingly few answers to some of the most fundamental and elementary problems involved in the choice of a capitalization rate. It is an interesting commentary on modern capitalism, as represented by the most highly commercialized country in the world, that the very processes that are most characteristic of money-making activities have never been thoroughly analyzed from the standpoint of actuarial science.

Summary.

In an enterprise appraisal, the first question to be settled is whether or not any or all of the assets should be valued at their net realization value or as a part of the "going concern." When the latter answer is required, the value of the enterprise depends entirely on the discounted value of the prospective earnings. But even so, if the enterprise has a value as a "feeder" to some related enterprise, this "control value" must be separately allowed for, since it is not reflected in the earnings reported by the enterprise in question.

The principle that "a business is worth only what it can earn" has sometimes been thought to outlaw any method of valuation save the one based on a capitalization of prophesied net earnings. It has been adduced, particularly, by those who deny the significance of book values or of so-called physical valuations of the corporate assets. No doubt this position is quite correct in so far as it is taken to mean that an asset valuation should be given no weight (save with respect to disposable assets) when it contradicts the best estimates of probable earnings. But a careful appraisal of the physical assets is indispensable as a guide to the forecast of earning power; and the tendency of modern financial writers to ignore the inventories and the balance sheets in favor of the earnings statements, is an excessive reaction from the opposite error of earlier days.

So far as concerns a pecuniary valuation of the corporate assets (as distinct from a canvassing of their mere capacity to perform their functions), the chief purpose of a physical appraisal is to guide the appraiser in estimating a reasonable annual allowance for depreciation and for various items in the operating-expense account. But the replacement cost of the physical assets may also have an indirect bearing on future corporate earning power, and hence on enterprise value, by indicating the "normal profits" that the company may expect to make under conditions of competition. With railroads and

(to an even greater degree) local utility enterprises, the original costs or replacement costs of the tangible assets may deserve consideration as affecting the rates which the company will be permitted to charge for its service under government regulation.

In all respects the relationship between the commercial value of a business and the so-called physical values of its assets is highly indirect and uncertain. Almost never does it justify an assumption that the "values" (that is, the depreciated costs) of the latter even roughly measure the value of the former.

When substantially all of the proprietary and creditor claims of an enterprise are represented by outstanding securities with readily ascertainable market prices, a summation of these prices gives a rough-and-ready appraisal of the entire enterprise, which is useful as a check method and which may even be accepted as final in a frankly crude valuation. But this "stock-and-bond" method of appraisal is subject to serious errors, and it is not so reliable as is a painstaking and unbiased appraisal based on a capitalization of prospective earnings. Its most serious error lies in its false assumption that the value of an entire enterprise is equal to the sum of the separate values of the minority interests in that enterprise.

In litigated cases, the question has often arisen whether "*realized* earnings" or "*future* earnings" are the better measure of the value of a business, or of a shareholding in the business. In fact, the question can be intelligently answered only if it is rephrased. "Future earnings" never get into the record as such.[33] What the court is faced with is a choice between the "realized earnings" reported by accountants, and the prospective earnings prophesied by witnesses for the contesting parties. If the prophecies could be relied upon, they would clearly deserve acceptance and the reported earnings might be utterly disregarded. But in fact, not only are the prophecies of hired witnesses often untrustworthy; their degree of reliability is almost impossible to establish by the procedure of cross-examination. Hence a court is often warranted in excluding them from the record, even though it admits reported realized earnings merely because of their bearing on probable future earnings. An expert tribunal, however, is in a better position than a jury, or even than most trial judges, to discount biased prophecies of future earnings. It is therefore warranted in placing less restrictions on opinion evidence of this nature.

[33] In a retrospective appraisal, where an enterprise is being valued as of an earlier date, the tribunal may have at hand the actual record of subsequent earnings. But the probative significance of this record is rendered controversial by the rules against "hindsight" valuations. See *infra* pp. 805, 1060–1063, 1072.

From both a theoretical and a practical standpoint, the choice of a proper rate of capitalization presents even greater difficulties than the determination of the earnings to be capitalized. Some of these difficulties have been noted in the previous section. But they have been given amazingly scant attention in the literature of finance and in the records of the litigated cases, perhaps because their solution has seemed hopeless. In consequence, the legally accepted rates of capitalization have been adopted by an admixture of tradition (such as that in favor of a 6 per cent rate or a 10 per cent rate) and guesswork.

PART III

VALUATION FOR SPECIFIC PURPOSES

CHAPTER XIII

VALUE AS A MEASURE OF INDEMNITY: THE LAW OF DAMAGES

INTRODUCTION TO THE INDEMNITY CASES

Despite important differences in detail, a large fraction of the thousands of lawsuits involving a valuation of property may be brought under the general heading of "indemnity cases." The significance of this category is that the valuation is made for the purpose of measuring the amount of some loss or injury for which one of the litigants has established a claim to compensation. In the words of Justice Lurton, speaking for the Supreme Court in an eminent-domain case, "The owner must be compensated for what is taken from him, but that is done when he is paid its fair market value for all available uses and purposes."[1]

The three fields of law selected for study as offering the richest case material on appraisals made under the influence of the indemnity principle are those of damages in tort and contract cases involving property, of eminent domain, and of fire insurance. Other, closely related fields, such as that of marine insurance, have not been canvassed. But even certain valuations covered elsewhere in this treatise, notably dissenting-stockholders' suits for a cash settlement (Chap. XXIV) and appraisals incidental to a corporate reorganization (Chap. XXV), might *seem* to belong under the same general heading. An explanation of our failure thus to classify them is therefore in order, especially so since this explanation will emphasize the distinctive character of a valuation designed to measure indemnity.

Distinction between Indemnity and Other Forms of Compensation.

The point just referred to can best be made clear by reference to the distinction between two different meanings of the term "compensation." Used in a strict and narrow sense, the word is an exact synonym for "indemnification" or "indemnity." When so used, it refers to a payment no more and no less than sufficient to make good

[1] U.S. v. Chandler-Dunbar Co., 229 U.S. 53 at 81 (1913).

the loss for which compensation must be paid. This is the sense in which it is used in the phrase "compensatory damages," and in which it is generally construed under the constitutional provision requiring the payment of "just compensation" for property taken under the law of eminent domain. In both of these situations, the award of damages is supposedly set at an amount which (with qualifications) will make the claimant as well off with the money but without his property, as he would be with his property but without the money.

But, when used in a broader and looser sense, "compensation" refers to *any* payment for property or services; and "*reasonable* compensation" refers to any payment deemed fair under whatever standard of fairness is accepted by the person who uses the term. In ordinary business transactions, the accepted test of a reasonable payment is by no means that of indemnity. On the contrary, the traditional notion of a "fair trade" is one that will result in mutual advantage to the buyer and the seller—*i.e.*, one that will *overindemnify* both parties for their respective sacrifices. In transactions of this nature, the familiar language of damage law referring to the objective of "making the owner whole," is out of place.

It may well be that, in the majority of those cases in which the *courts* find it necessary to set the compensation payable for the loss or transfer of property, the principle of indemnity supersedes the ordinary principle of a "fair trade." But this is by no means the invariable rule; and the student of legal valuation must be alert to discover possible distinctions between these two standards of payment. Even under the laws of damages and of eminent domain, the "fair-trade" notion often has a subtle influence on the valuation, derogating from the strict indemnity notion.[2] But in certain other fields of law, the indemnity doctrine is flatly rejected in favor of the principle of an ordinary voluntary sale. Thus, if a physician sues a patient for his fees, in an action of *general assumpsit*, he is by no means restricted to a recovery for his out-of-pocket expenses plus his lost opportunity to serve another patient. Instead, he is entitled to recover on the count of "*quantum meruit*"[3]—to recover the amount "which he deserves," determined by looking at the services from the standpoint of worth to the patient no less than of loss to the physician.

[2] For example, in eminent domain, where some courts have failed to adhere to the logic of their doctrine that compensation shall not take into account the special value of the property to the taker: *infra* pp. 422–426.

[3] "*Quantum valebat*" is the common count in similar actions to recover for goods sold and delivered without an express agreement as to price.

In certain of the newer fields of law, the rules of valuation are in too early a stage of development to warrant a confident generalization as to applicability of the indemnity principle. This statement applies notably to those branches of corporation law discussed in Chaps. XXIV and XXV; and as a matter of caution we have therefore declined to classify these chapters along with those now presented.

The Bearing of the Indemnity Principle on the Concept of "Value."

From the standpoint of value theory, the significance of the indemnity principle is that it would seem to require a concept of value which identifies, or at least closely associates, "what the property was worth" with what the owner has lost as a result of the deprivation. Only one value concept meets this test—namely, that of "value to the owner," discussed at length in Chap. IV. Certainly neither original cost nor replacement cost will serve the purpose, except when it happens to be an approximate *measure* of value to the owner; nor is *market* value acceptable, save in those instances in which the price at which the property could be marketed reflects with reasonable accuracy its value to the specific person who has a claim for compensation.

But what makes these cases so puzzling to those who would try to explain the rulings on valuation by reference to the indemnity principle, is that in only a small minority of the opinions is "value to the owner" expressly adopted as the measure of the award. Instead, "market value" or "fair market value" is the usual verbal standard. To be sure, when the property is held to "have no market value,"[4] mere realization price has been rejected on the ground that it would fail to indemnify. Occasionally, moreover, a court has refused to accept market value as the criterion even when it concedes that the property "has a market value."[5] But even when making these exceptions to the market-value test, the courts have often invoked some standard, such as "real value," or "fair value," the nature of which is undefined. Many judges still cling to a concept of value *inherent in the property itself*, and independent of the relationship between the property on the one hand and the owner's personal situation on the other hand.[6]

[4] For mention of such holdings, see index under No market value, property having.

[5] For example, in the valuation of secondhand consumers' goods, *infra* pp. 344–346.

[6] Illustrated by the Washington Mills fire-insurance cases, discussed *supra* pp. 21–22, and *infra* pp. 393–394. See also Chap. V, especially p. 109.

Why do the courts, despite all their talk about "making the owner pecuniarily whole," appear to reject the logic of their doctrine by invoking other concepts of value than that of value *to the particular owner?* A combination of several answers is suggested, and they may be noted here in order to indicate the significance of the detailed rulings later to be discussed.

In the first place, even if the law were to recognize "value to the owner" as the *ideal* standard of compensation, it would still face the extreme difficulty of determining the amount of this value. Highly speculative questions would be raised as to the peculiar relationship between the owner and the property, and as to the opportunity that the owner has had to minimize his loss by replacement or otherwise. No wonder, then, that the courts have been reluctant to make the award depend on an appraisal of such a controversial nature. No wonder that they have preferred more objective standards, like current market price or estimated replacement cost. Some judges, indeed, have frankly defended a market-value test on the ground that, while it may leave the owner without full compensation, it is nevertheless the most *practical* measure of indemnity at the command of the law. Another point which they might well make is that, in the hands of an untrained jury or trial judge, the value of property to a given owner is quite generally overestimated; for, as a rule, most tribunals err on the side of overvaluation.[7] In eminent domain, for example, even the prevailing American doctrine that real property shall be appraised merely at its *market* value has not precluded actual awards which, by and large, have almost certainly exceeded the special worth of the property to the owners themselves. Even more grossly excessive awards might well result from an overt legal requirement that this special worth be included in the compensation.

In the second place, the courts have not in fact departed as far from a "value-to-the-owner" standard as might be inferred from their *verbal* use of the market-value test. We have already noted that "market value" itself is an ambiguous term, especially so when identified with a "*fair* market value," conceived as something different from the price called for by the cold-blooded verdict of the market place.[8] Through this loose use of an economic term, the courts have gone a long way toward bridging the gap between market value in a strict sense and value to the owner. By invoking the concept of a mythical "willing buyer," or by choosing, now selling price, now buying price, as the "measure" of market value, they have often arrived at

[7] See *infra* p. 449, note 89, and pp. 1187–1189.

[8] Chap. III, especially at pp. 59–61; index under Fair market value.

results not very different from those that an appraiser might reach were he to attempt to estimate value to the owner. As will be noted later, the "willing-buyer" fiction is especially important in real-estate valuation under the law of eminent domain, whereas the freedom of choice between several markets (manufacturers', wholesalers', retailers') is of great significance in the damage cases involving chattels.

In the third place, despite many loose dicta to the contrary, the law does not even *purport* to permit an owner to recover for *all* the injuries that he may have suffered by virtue of the loss of the property. "Sentimental values" and "incidental losses" are generally excluded from consideration, with qualifications discussed below. Under a market-value test, they *can* be left out of account; but under an unrestricted value-to-the-owner test, they would have to be included in the award. It is only a half-truth to say, as the Supreme Court has frequently said in discussing the law of damages or of eminent domain, that the objective of the valuation is to "make the owner whole" for his loss. Even when limited to "*pecuniary* loss," this statement is still too sweeping.

The Legal Use of the Value Concept to Distinguish between Recoverable and Non-recoverable Losses.

In explaining the reluctance of the courts to base compensation for lost or non-acquired property on the special value of this property to the claimant, we have already noted that the law does not purport to grant recovery for all losses resulting from the act that gives rise to the claim for damages. Instead, the claimant is often entitled to an award measured by the *mere* "value" of the property, with no allowance for any "incidental" or "consequential" injuries.

This use of the value concept as a device by which to distinguish between recoverable and non-recoverable losses extends throughout the law of property. But its importance is obscured by the misleading assertions, made in many of the reported opinions, that an owner who is deprived of his property is fully indemnified if he recovers a sum of money equal to its "fair market value."

In a later section of the present chapter, we shall recur to this distinction between the plaintiff's full loss and that part of his loss which is reflected in the market value of the property. What now requires emphasis is the use of the *same* value concept to distinguish between recoverable and non-recoverable losses in *different* fields of law, where *different* reasons are assigned for drawing the distinction. We may illustrate this point by a comparison of the accepted measures

of recovery under the laws of (*a*) breach of contract, (*b*) tort, (*c*) standard fire insurance, and (*d*) eminent domain.

In the contract cases in which the buyer is suing a vendor for non-delivery of merchandise, recovery is often limited to market value minus contract price, for the asserted reason that the defendant could not fairly be presumed to have contemplated that his breach of contract would result in any larger loss. In the tort cases, recovery is often limited to "market value" for the asserted reason that any loss in excess of this value was not "proximately caused" by the defendant's wrongdoing. In the fire-insurance cases, recovery may be limited to "fair market value" or "fair value" on the ground that any further loss is not insurable under a standard form of policy. And in eminent domain, compensation may be restricted to the "market value of the property that has been taken" on the ground that a merely incidental injury to the owner's remaining property, or to his personal status, does not constitute a "taking of property."

Here we have four apparently different reasons for distinguishing between losses that are almost invariably recoverable, and losses that are recoverable, if at all, only under certain circumstances. Yet, in each of these situations, the law makes use of the same device by which to draw the line of demarcation—the device of a value concept that ignores the claimant's peculiar uses of the property in question. With a number of important exceptions, the result is the same even though the declared reasons for reaching this result are different.

As a matter of logic, of course, there is no necessary inconsistency in a recognition of *different* reasons for making the *same* distinction between recoverable and non-recoverable losses. Nevertheless, the situation is sufficiently striking to call for an attempt at an explanation. Of the various explanations that might be suggested, the two following ones seem to us the most plausible.

In the first place, the asserted reasons for drawing the distinction are not so far apart as they appear to be on their face. All of them may have their roots in a basic distinction between losses that might, and losses that might not, be contemplated as likely to have resulted from the loss of the property, in the light of a somewhat superficial knowledge of the property and of the conditions of its ownership.

This distinction is overtly recognized in the rule in *Hadley v. Baxendale*, applicable to breaches of contract. But it is implicit in the analogous doctrine of proximate causation, applicable to tort cases. Indeed, some writers have declared that these two doctrines are mere restatements of the same fundamental principle. Even in those fire-insurance cases in which the claimants are precluded by the terms

of standard policies from recovering more than the "value" of the destroyed property, the distinction between losses insurable under these policies and losses insurable only under other policies is designed, in large measure, to recognize the higher predictability and measurability of the first type of loss as compared to second type. With eminent domain, the analogy becomes more difficult to maintain. Yet, even here, the fact that "incidental losses" are less predictable by the government or agency that is contemplating condemnation proceedings, suggests *one* reason why the courts are loath to require the payment of compensation for such losses.

Another possible explanation may be considered—one that is very difficult, however, to evaluate. May not the distinction between recoverable and non-recoverable losses be a more or less accidental result of the intrusion into the indemnity cases of value concepts coming from the market place and the counting house—concepts that identify "value" with buying or selling price rather than with loss avoidance?

One can readily see how this accident *might* have happened. Let us imagine ourselves in the role of a judge who is awarding to a farmer compensation for the loss of a cow, and let us suppose that we are facing this problem uncontrolled by any rule of law except the principle that the award must make the farmer as well off with the money but without his cow as he would have been with his cow but without the money. Almost inevitably we turn to a *valuation* of the cow as a means of striking this balance. For, after all, the loss of the cow was a loss of nothing measurable if not a loss of its *value*. But, having reached this first step in our procedure, we now find ourselves in trouble because the witnesses for the farmer are apparently construing or "measuring" value in one way, while the witnesses for the defendant are construing or measuring it in another way. So we turn to the textbooks and the law reports on the subject of valuation. And we find that most of the cases support most of the textbooks in defining "value" to mean "market value." Thereupon we instruct the witnesses that they must address themselves to the problem of estimating the *market* value of the cow, forgetting or disregarding the fact that, when we first became interested in its *value*, we were then construing "value" to mean what the cow was worth to the particular farmer.

Of course, this imaginary illustration is too simple adequately to reflect the thought processes of the courts. But it suggests a point of approach for a study that might possibly throw a flood of light on the judicial tendency—so puzzling to many laymen—to grant better protection to marketable property rights than to other interests that

are denied this halo of sanctity. We do not press the point, however; for its merits could be determined only by persons with a profound knowledge of the development of legal institutions, including institutions other than that of Anglo-American law.

THE LAW OF DAMAGES*

I. Introductory.

The law of damages furnishes, perhaps, the best starting point for a study of theories of valuation developed by the courts. In the first place, along with the related law of eminent domain, it is the field of Anglo-American law in which most of the existing concepts of value had their origin.[9] In the second place, it probably furnishes a greater number of cases than any other field. In the third place, the types of property involved are generally of a simple nature, giving rise to no such complex problems as are raised, say, by the valuation of a public-utility system for rate-making purposes.

On the other hand, cases in the law of damages are on the whole less interesting both to the student of economic theory and to the appraisal specialist than are the more intriguing fields of public-utility valuation, eminent domain, taxation, and stock watering. The damage problems are of less importance from the public point of view than are those arising in these other fields of law. Moreover, the relative

* This study was commenced by C. S. S. Epstein and David Katz, and completed by Joseph L. Weiner in collaboration with the author, and with the assistance of Myron N. Krotinger and Milton Sandberg. Revisions have been made as a result of valued suggestions by Professor Charles T. McCormick, of the Northwestern University School of Law, who did us the favor of reading proof.

We here use the term "law of damages" to cover only claims for losses due to acts traditionally thought of as "wrongful." Hence, the present study is limited almost entirely to actions in tort and for breach of contract. Only damages involving property are considered. But on the monetary valuation of a human life, see Louis I. Dublin and Alfred J. Lotka, *The Money Value of a Man* (New York, 1930).

The standard treatises are T. Sedgwick, *Damages* (8th ed., rev., New York, 1912), and J. G. Sutherland, *Damages* (4th ed., Chicago, 1912). See also B. B. Clark, *New York Law of Damages* (Northport, N.Y., 1925). Charles T. McCormick's recent *Handbook on the Law of Damages* (St. Paul, Minn., 1935) presents a notable shorter discussion and is unusually sound in its treatment of valuation.

[9] But Nathan Matthews, in "The Valuation of Property in the Early Common Law," 35 *Harv. L. Rev.* 15 (1921), points out that even under the law of damages, the judicial rules of valuation are of comparatively recent origin. In earlier days, the jury was left almost completely free to fix compensation. Compare Matthews, "The Valuation of Property in the Roman Law," 34 *Harv. L. Rev.* 229 (1921), indicating the use of the concept of value to the owner.

insignificance of the claims at stake in the typical damage case has prevented the nicer issues in the theory of valuation from being raised by the litigants, argued by the experts, and discussed by the courts.

Nevertheless, the law of damages cannot be neglected even by the student of value theory; for it presents, more frequently than any other field, the numerous but ill-defined distinctions between the "value" of any given property as conceived by the courts, and the amount of money that would exactly indemnify the owner for the loss of this property.

The Role of Valuation in the Measurement of Damages.

One of the chief characteristics of Anglo-American law, as distinguished from Roman law and its derivatives, is the overwhelming importance of a money award as a remedy for a civil injury. Only in exceptional instances does the former legal system afford specific relief by commanding performance of a promised act or by enjoining performance of a prohibited one. Questions as to what injuries give rise to liability for money damages, and as to the measure of these damages, therefore pervade almost the whole field of our civil law. The student of valuation, however, is interested only in the latter question; and even this interest is limited to those cases in which the amount of recovery is determined, in whole or in part, by a "valuation" of property.

Even in damage cases involving property, the courts have not always found it necessary to determine the "value" of the property in order to fix the proper award. Sometimes, they have instructed the jury to estimate directly the loss suffered by the plaintiff as a result of the destruction or non-acquisition of the property in question. But this procedure is somewhat exceptional; for the most part, damages have been measured, in whole or in part, by a valuation of the property at a specified time and place.[10]

We may illustrate this point by reference to the usual rules of recovery in breach of contract and in tort. For the failure of a vendor to perform a contract for the delivery of goods, the ordinary measure of damages that the purchaser may recover is the excess in the "value" of these goods at the promised time and place of delivery, over the price which the purchaser has agreed to pay for them.[11] Conversely,

[10] "In almost all cases in which damages are recoverable, the measure of compensation involves an inquiry into the question of value." Sedgwick, *Damages*, Vol. I, p. 489.

[11] Uniform Sales Act, §67; Williston, *Sales*, Vol. II (2d ed., New York, 1924) 1476 *ff*. See Restatement, Contracts (1932) §329.

when the purchaser defaults on a similar contract, he is ordinarily liable for the excess in the contract price over the "value" of the commodities at the time and place of the promised delivery.[12] Sometimes, the aggrieved party may recover "special" damages. But even in such cases, the special allowance frequently takes the form of a separate item in addition to the "general" damages determined by a valuation of the property involved.

In the various forms of tort actions, where the owner has suffered a complete loss of property, the "value" of this property, at some time and place depending upon the circumstances and upon the form of action, is the more usual measure of damage.[13] Where property has been merely injured, one of two measures of recovery is the standard choice: either the cost of restoration, or the fall in value of the property.[14]

The role of valuation in damage law is therefore obvious. From the point of view of this treatise, the primary question is, What does the court here mean by "value of the property"? Does it mean the same thing in the law of damages that it means in the law of eminent domain, or of public-utility rate making, or of property taxation? Is there one fixed meaning of the term "value" in the field of damages, or does "value" even here mean one thing in one type of case and something else in another type of case? Is the "market value" of a ton of coal the same for the mineowner, the dealer, and the consumer? Problems of this nature form the central interest of our present study.

II. The Assumed Principle of Full Indemnity versus Conflicting Principles or Rules of Recovery.

Judges, in their reported opinions, frequently talk of indemnity as the master principle and refer to valuation as merely a helpful tool for the attainment of this end. "In civil actions," wrote Judge Rapallo, "the law awards to the party injured a just indemnity for the wrong which has been done him, and no more, whether the action be in contract or in tort."[15] And since his day, many courts have been using language to the same effect.

Quite aside from these formal expressions of doctrine, the rulings go a considerable distance toward bearing out this profession of legal intent. Indeed, there appears to be an increasing tendency on the

[12] Uniform Sales Act §64; Williston, *Sales*, Vol. II, at 1432 *ff*.

[13] Sedgwick, *Damages*, Vol. II, at 832 *ff*.

[14] *Ibid.*, Chaps. 18 and 41.

[15] Baker v. Drake, 53 N.Y. 211 at 220 (1873).

part of the courts to emphasize the principle of indemnity and to belittle those traditional rules of damages that are in clear conflict.

Nevertheless, a search through the reported cases reveals an impressive number of rules or doctrines, the adherence to any of which must often involve a violation of the assumed standard of exact indemnity to the plaintiff for the loss unavoidably resulting from the wrongful act of the defendant. Why these rules were established is a question of no direct concern in a treatise on valuation. But the fact that they are often actually applied cannot be ignored by us, since it has an important bearing on the judicial interpretation of the phrase "value of the property."

We may first note the diminishing, but still considerable, body of cases in which the law awards punitive damages, or "smart money." Here, the award may be frankly in excess of the injury sustained, and frankly in excess of the "value" of the destroyed property. Of more interest for value theory are those cases in which, with the object of preventing "unjust enrichment," the award is measured by the gain to the wrongdoer rather than by the loss to the plaintiff. This object is often accomplished through the acceptance of "methods of valuation" that are rejected in cases which follow the indemnity principle.[16]

In both of the above situations, the courts do not even *purport* to be attempting merely to "make the plaintiff whole." But other rules that derogate from the assumed standard of full indemnity are applied even in those cases in which the courts *talk* as if they were awarding "compensatory damages." The more important of these rules may now be listed; but those that have little bearing on the problem of valuation will be dismissed with a brief comment.

1. *Failure to Allow Full Costs of Litigation.*

One of the serious indirect losses that may be sustained by the injured party as a consequence of a tort or breach of contract, is the time, anxiety, and expense of litigation. To the extent that the plaintiff fails to secure adequate compensation for these losses, he is not fully indemnified. Yet the legal costs allowed to the successful plaintiff are usually far less than his actual counsel fees, to say nothing of his other expenses and loss of time.[17]

[16] See index under Unjust enrichment, doctrine of. Even in cases awarding so-called compensatory damages, one suspects that the courts sometimes have in mind the unjust-enrichment notion, or the related notion of punishment, as a reason for refusing to depart from a mechanical rule of appraisal despite convincing evidence that its application will result in overindemnity.

[17] Sedgwick, *Damages*, Vol. I, p. 45, quotes from his earlier article as follows: "In the most ordinary case of a suit on a note of hand, the damages do not amount

2. *Inadequate Allowance of Interest.*

The practice of the courts has been illiberal in the allowance of interest on the amount of the award, to compensate for the delay between the time when the injury was sustained and the time of entry of judgment.[18] This practice has been substantially modified by statute;[19] but in any event, the rate is arbitrarily determined, generally at 6 per cent,[20] quite without reference to the peculiar circumstances of the plaintiff. In breach of contract, for example, situations may and doubtless do arise in which the failure of one party to fulfill his contract imposes upon the injured party the necessity of raising funds at once in order to avoid breaking his own contracts with third parties. Inability to raise this cash may have the most serious consequences and may even result in bankruptcy. Yet the courts do not take into account the circumstance that the "time value" of money to this particular plaintiff has greatly exceeded any conventional rate of interest.[21]

3. *Failure to Allow for Changes in the Value of Money.*

If a person suffers an injury at a time when the general level of prices is relatively low, an amount of money that would compensate

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to compensation. Who pays the counsel fees? Who pays for the time of the plaintiff? Who pays for his annoyance and vexation? The most successful lawsuit is too often a Barmecide feast." This situation has been aggravated by the expense of procuring necessary "expert" testimony.

The statutes usually provide for additional allowances in specified types of cases, frequently ill-chosen (N. Y. Civil Practice Act (1920), §§ 1512–1517). In England and on the European continent, the matter of court costs is handled more sensibly.

It may be noted that in eminent domain, where there is no implication of wrongdoing on the part of the taker, allowances for counsel fees are sometimes made, although they are not usually granted. See Philip Nichols, *The Law of Eminent Domain* (2d ed., Albany, 1917), p. 966. Such allowances are not made to the successful plaintiff in an action against a converter or other wrongdoer.

[18] Sedgwick, *Damages*, Vol. I, Chap. 15.

[19] N. Y. Civil Practice Act (1920) §480. The Restatement, Contracts (1932) §337, permits the recovery of interest from the time of performance where the defendant breaches a contract to pay over a definite sum or render a performance the monetary value of which is stated in the contract or is readily ascertainable.

[20] The statutory rate of interest is sometimes identical with the maximum allowed by usury statutes; *e.g.*, each is 6 per cent in New York. But the rates sometimes differ; *e.g.*, in Florida, where judgments bear interest at 6 per cent but where some other obligations may bear 10 per cent.

[21] For similar reasons the courts have been reluctant to grant more than nominal damages for breach of a contract to lend money. Sedgwick, *Damages*, Vol. II, pp. 1213–1217. The theoretical right to recover substantial damages is recognized, however. Restatement, Contracts (1932) §343.

him if paid to him at once, will fail to compensate him if paid only after prices have risen. Conversely, if the injury occurs during a period of high prices and if the award is paid during a period of low prices, the plaintiff may be overcompensated to the extent that the dollars which he receives have increased in purchasing power. Almost uniformly, however, the courts have ignored those changes in the value of money that intervene between the time of injury and the time of judgment. So firmly fixed is this tradition, that courts seldom find it necessary even to apologize for this departure from the principle of indemnity.[22] But a wholly different attitude appears where the action involves foreign money.[23] And even in a few other special types of damage suits, the courts have made allowance for a change in price level.[24]

4. *Failure to Allow for Changes in the Value of the Property.*

A distinction must be drawn between changes in the value of *money* and changes in the value of the injured or lost *property*, as affecting the balance between the loss suffered by the plaintiff and the amount of his recovery. The former situation may be illustrated by the case of a plaintiff who is now recovering damages for conversion of a bond of

[22] In so far as it is defended, the defense rests partly on the argument of the soundness of legal tender (carrying with it the fiction that the value of the currency does not change), and partly on the practical ground that any attempt to allow for the changing value of money would involve too many difficulties in the administration of justice. See the Legal Tender Cases, 79 U.S. 457 (1870); Dooley v. Smith, 80 U.S. 604 (1871); Juilliard v. Greenman, 110 U.S. 421 (1884).

Sedgwick, *Damages*, Vol. I, p. 530, states: "The monetary system of a country may, however, between the time of contract and the date of payment, be disturbed and altered in one of two ways: the currency may become depreciated, or a new standard may be adopted. In such cases the contract will be discharged by a due payment in any money which by law is made of equivalent value at the time of payment" (citing cases). See also McCormick, *Handbook on the Law of Damages*, pp. 190–198.

[23] We have considered these cases in a separate study: Simon H. Rifkind, "Money as a Device for Measuring Value," 26 *Col. L. Rev.* 559 (1926). Numerous other studies have appeared since then.

[24] In cases involving physical injuries, courts, in awarding a greater sum for a type of injury, such as loss of one arm, than was approved in some earlier cases, have taken cognizance of a decrease in the purchasing power of money. See 35 *Harv. L. Rev.* 616–617 (1922); *cf. infra* p. 1188, note 6. McCormick, *Handbook on the Law of Damages*, p. 197, calls attention to Willard v. Tayloe, 75 U.S. 557 (1869), where one who sought specific performance of an option contract to sell land, made before the Legal Tender Acts but calling for performance thereafter, was required to do equity by tendering the price in coin, since that form of payment was contemplated by the seller when the contract was made.

unchanging market price, which was converted at a time when price levels were half as high as they are now. The latter situation may be illustrated by the case of a plaintiff who is recovering for the conversion of corporate stock which was worth $1,000 on conversion date, but which is now worth $2,000 despite the fact that general price levels have remained stable. In the former case, an award of $1,000 might well fail to compensate the plaintiff, because this amount of money is "worth only half" as much as it was at the time when his property was taken from him. In the latter case, an award of $1,000 might fail to make good the loss suffered by the plaintiff, because, if he had not been deprived of his stock, he might well have retained it down to the present time. In other words, he might have been in possession of property worth $2,000 on judgment day, as against a judgment for $1,000. Of course, we cannot be sure that the plaintiff would not have sold at some intermediate date, at more or less than either breach-day or judgment-day value; or that he would not still have retained his stock, subject to further fluctuation. Obviously, therefore, no rule as to the time as of which the property shall be valued could result in awards that more than roughly approximate indemnity.

Partly, no doubt, because of the impossibility of knowing how to shift the time of valuation in such a way as to secure an accurate measure of indemnity in individual cases, the courts have generally fixed upon some arbitrary date, usually the date when the contract was to have been performed or when the tort was committed, as setting the valuation date.[25] But they have departed from the general rule in cases where the property is of a type subject to more than ordinary price fluctuation. These cases will be discussed in the next chapter.[26]

Even the arbitrary rules setting the date of valuation, though intended to simplify the administration of damage law, present numerous difficulties of application. Definite content can be given to them only when the different types of actions are studied. This refers, not only to the various fact situations, but also to the different procedural forms from among which the plaintiff can choose in a given situation. A detailed discussion of the possibilities would be lengthy and tedious; the following comments may be taken as illustrative.[27]

[25] For the rule in contract cases, see Uniform Sales Act §§64, 67; Williston, *Sales*, Vol. II, pp. 1434, 1478. See also Restatement, Contracts (1932) §329. For the rule in tort cases, see Sedgwick, *Damages*, Vol. II, p. 834.

[26] *Infra* pp. 319–321.

[27] The discussion does not include consideration of different procedural devices. Despite the gradual abolition of traditional language in formulating a complaint, the procedural concepts are still influential in determining results. And they are intertwined with concepts of the nature of the wrong, and hence of the time of its

The measure of damages for breach of a contract to buy or sell is based upon value at the agreed time for performance. But difficult questions may arise in determining when performance is due, as in a contract to deliver goods when produced. Such questions are settled by the substantive law of contracts, and the determination of these technical and abstruse questions automatically sets the time of valuation. This setting may be defended on grounds of administrative convenience, although it often belies the usual definition of the breach-day rule, namely that the plaintiff would justifiably have replaced at the time performance was due but failed.

A further question naturally arises. Shall the time when performance was due be selected even when the plaintiff does not become aware of the breach until a later time? Here, many courts make distinctions when the breach has taken place at a distant city, for example, through failure to ship.[28] Conflicting decisions have been made in cases of so-called anticipatory breach, that is, where one party repudiates his promise prior to the time agreed upon for his performance. The repudiation is itself regarded in law as a breach,[29] justifying the other party both in ceasing further performance and in bringing his action for damages. Suit may be brought or even concluded prior to the time scheduled for performance, or concluded afterward, or not commenced

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occurrence. For example, where a car is stolen by *B* from *A* in New York, sold to *C* in New York, and driven by *C* to California, some courts hold that *C* "converted" the car at the time of his purchase, whereas others hold that there is no conversion until *C* refuses to return the car upon demand, which would have to be made in California. Both the time and place of valuation are thus affected. Neither rule applies to the action of replevin, in either its common-law or its statutory form, where the value at the time of trial is used, together with damages for "detention," if claimed.

Some indication of the importance of procedural differences is apparent from the leading case of Smith v. Bolles, 132 U.S. 125 (1889), where a buyer sued for damages suffered from the seller's fraud in inducing the sale. The buyer wanted the value of the property as represented. The Court held otherwise, stating: "What the plaintiff might have gained is not the question, but what he had lost by being deceived into the purchase. The suit was not brought for breach of contract." An interesting recent case showing the importance of procedural concepts is I. Tannenbaum Son & Co. v. C. Ludwig Baumann & Co., 261 N.Y. 85, 184 N.E. 503 (1933), commented on in 33 *Col. L. Rev.* 1067 (1933).

[28] Boyd v. L. H. Quinn Co., 18 Misc. 169, 41 N.Y. Supp. 391 (Sup. Ct., 1896); Ashmore v. Cox & Co. [1899] 1 Q.B. 436; see Perkins v. Minford, 235 N.Y. 301, 139 N.E. 276 (1923). A number of analogous cases are discussed, and some criticized, in McCormick, *Handbook on the Law of Damages*, pp. 666–667.

[29] The literature on this subject is voluminous: see Williston, *Sales*, Vol. II, pp. 1440 *et seq.;* H. R. Limburg "Anticipatory Repudiation of Contracts," 10 *Cornell L. Q.* 135 (1925); Restatement, Contracts (1932) §318 *et seq.*

until afterward. The plaintiff may have replaced at once, either in the spot market or by a forward contract, or he may never replace. If the time of repudiation is taken, the choice will be the spot or futures market. If the performance date is past at the time of trial, value at that date presents an obvious alternative. The United States Supreme Court[30] has said that, where the trial takes place before performance date, the futures market on repudiation date is a proper measure of damages. The New York courts,[31] where most of such litigation is found, have held that, if the value on performance date is known, this value measures the award unless the plaintiff in fact made substitute contracts within a reasonable time after repudiation.

Closely related to the question, What time? is the question, What place? There are many reasons why the same property, in the same type of market, may command different prices at different places. And the market at the different places in question may not be the same.

In a previous footnote (note 27), we indicated that different rules as to determining "time" may lead to different results as to "place." We shall consider later some applications of the ordinary rule as to place of valuation. Here we may mention the most important special problem, which arises in connection with goods being transported or awaiting transportation. In the admiralty courts[32] the almost universal rule is that values should be taken at the point of shipment. What was actually paid for the goods, plus shipment charges, insurance, interest, and other expenses, constitutes the recovery, no matter how near the goods were, at the time of destruction, to a market in which they would have commanded a much higher price. Where, however, this rule cannot be applied, as in the case of fish taken from the sea, the admiralty courts will sometimes look to value at the point of destination or at the place nearest to that of the loss.

In the law courts, however, where the action is against a carrier for goods lost in transit, the value is always taken at the point of destination, regardless of where the loss occurred.[33] Where the loss occurs

[30] Roehm v. Horst, 178 U.S. 1 (1900). See Restatement, Contracts (1932) §338.

[31] John Dimon Corp. v. Federal Sugar Refining Co., 215 App. Div. 140, 213 N.Y. Supp. 106 (1st Dept., 1925); see cases collected in a Note, 34 A.L.R. 114 (1925).

[32] Sedgwick, *Damages,* Vol. II, pp. 1145–1147.

[33] Sedgwick, *Damages,* Vol. III, pp. 1747–1753. The same rule is generally applied where the property is destroyed or converted by a person other than the carrier, while in transit. Wallingford v. Kaiser, 191 N.Y. 392, 84 N.E. 295 (1908). (Horses en route from Chicago to Liverpool were destroyed in Buffalo.) A dissenting opinion in this case says: "American horses, raised, purchased, and

while the goods are in the hands of a carrier before transportation has begun, the cases are divided[34] as to whether the plaintiff can recover value at the point of destination or only at the point of shipment. Under either rule, no mention is made of the time when the plaintiff receives notice of the loss.

We have considered these rules of time and place in some detail because they are more complex than are those other rules that often conflict with the assumed objective of precise indemnity. The variety of decisions shows how the courts now conform to, and now depart from, the principle of indemnity.

5. *Rule against Allowance for "Sentimental Value."*

The familiar legal doctrine that no recovery may be had for the "sentimental value" of lost or destroyed property is obviously inconsistent with the standard of full indemnity. To be sure, "indemnity" itself may be so defined as to preclude compensation for losses of a purely sentimental nature. But such a definition is an artificial one, designed simply to make the legal tradition against allowance for sentimental values appear to square with the doctrine that the object of the award is "to make the plaintiff whole."

In the next chapter[35] it will be noted that the courts do not mean literally what they say when they declare that no allowance shall be made for sentimental value; for if literally construed, their statement would preclude anything but nominal damages for types of property, such as family portraits, that have no value to anyone if not a sentimental value. But the rule means something, even though not just what it says. And to the extent that it cuts off allowance for sentimental value, it is a derogation from the principle of indemnity.

6. *Doctrine against Allowance for "Speculative Damage."*

The term "speculative damage" is used sometimes to denote an alleged injury the very reality of which is doubtful or speculative, and

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converted in America, should be valued according to the American markets, rather than the English, even if they are on their way to England when converted." (Italics ours.) Seemingly it is assumed that the value at the place of destination is higher than at the place of shipment or intermediate points; and therefore that, if the plaintiff chooses to prove value at one of the latter points, he may do so.

[34] There may be a special rule limiting recovery in sea voyages to port of shipment values as against port of destination values, comparable to the admiralty rule. Krohn v. Oechs, 48 Barb. 127 (N.Y. Sup. Ct., 1866); Lakeman v. Grinnell, 5 Bosw. 625 (N.Y. Super. Ct., 1859). See Standard Marine Insurance Co., Ltd. v. Scottish Metropolitan Assurance Co., Ltd., 283 U.S. 284 (1931).

[35] *Infra* pp. 350–353.

sometimes to denote an undoubted injury the seriousness of which is speculative.[36] The loss of an interest in an undeveloped mine which will prove to be worth at least $100,000 and at most $1,000,000 might be said to be a speculative damage in the second sense; for the amount of the loss (though not its occurrence) can only be guessed at. But the loss of an unsalable lottery ticket which is likely to prove literally worthless would be a speculative damage in the first sense. Stricter usage limits the term to the first meaning, though there can be no clear-cut line of demarcation between the two uses. There is a general doctrine against the allowance of speculative damages both in the tort and breach-of-contract cases and in eminent domain. The doctrine is by no means to be taken literally, no more than is the doctrine against an allowance for sentimental value; but it nevertheless operates to exclude recovery for injuries that not infrequently prove to be both real and serious.[37]

7. *Delimination of Recovery to Injuries That Were (a) "Reasonably Contemplated" or (b) "Proximately Caused."*

Perhaps the most important derogation of the law of damages from the principle of indemnity is to be found in the rules denying recovery for certain of the unavoidable injurious consequences of those acts of a defendant that constitute the cause of action. These rules are of great significance for the student of valuation, since they purport to set up certain distinctions, difficult to justify on grounds of economic analysis, between the "value" of property of which an owner has been deprived, and the amount of the harm done to the owner because of this very deprivation.[38] The two most important rules are the rule in *Hadley v. Baxendale*[39] as applied to breach of contract, and the rule against recovery of remote, as distinct from proximate, damages in tort actions.

a. The Rule in Hadley v. Baxendale. Stated in the words of this classic case, the rule is:

> Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either aris-

[36] See a Note, 28 *Col. L. Rev.* 76 (1928).

[37] See *infra* pp. 348–350.

[38] See *supra* pp. 71–74.

[39] 9 Ex. 341 (1854). Sedgwick says (*Damages*, Vol. I, p. 263, n.9): "So entirely is the later law founded on this case, that the great body of cases since decided involving the measure of damages for breach of contract, resolve themselves into a continuous commentary upon it." See Restatement, Contracts (1932) §330.

ing naturally, *i.e.*, according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.

The field in which the rule is invoked is a broad one. *P* purchases from the X Cement Company a quantity of cement to be delivered to a certain address where *P* is constructing a building. A delay of 10 days in the delivery causes a similar delay in the completion of the building and subjects *P* to a penalty of $1,000 per day, which he has agreed to pay for each day's delay in completion beyond the contract date. Is the X Company liable to *P* for $10,000? Or, *B* may have purchased from the Y Company a quantity of merchandise to be delivered upon a given day, upon which *B* is himself to make delivery under a very profitable resale contract. The Y Company fails to deliver, and *B* loses the benefit of the resale contract, which is at prices much higher than current market prices. Is the whole of this loss to be visited on the Y Company? Again, *C* purchases pipe from the Z Company, informing it that the pipe is needed at once and that a rainstorm would cause the ditch to cave in before the pipe could be laid. The Z Company does not deliver and a storm causes *C* substantial damage. What is the Z Company's liability?

In all of these cases the decision is likely to turn on what the defendant knew, or should have known, at the time he made the contract, as to the loss which the plaintiff would suffer through a breach. The rationale of the rule has varied from time to time and with different apologists. But the fact remains that the rule presupposes a possible distinction between the total loss to the plaintiff as a result of the defendant's wrongful conduct, and that part of the loss for which compensation must be paid.

b. Proximate versus Remote Damages. While the rule in *Hadley v. Baxendale* is limited to contract cases, an analogous rule has been promulgated in connection with wrongful takers and injurers of property. The rule is that such persons are liable only for the "proximate" or "direct" consequences of their torts and not for the "remote" or "consequential" results.[40] Thus, if I negligently destroy your motorcar while you are driving it, it is conceded that I shall have to pay for the personal injuries suffered by you and also the price of another car (perhaps only the cost of the destroyed car less the depreciation); but I am *not* required to pay for the loss suffered by reason of the fact that the resulting delay has caused you to miss the closing of a very profitable contract. It may have been "probable" that you would be

[40] Sedgwick, *Damages*, Chap. 7. See Restatement, Torts (1934), Chap. 16.

late for work, but not that you would lose such an enormous benefit by the delay.

8. *Arbitrary, Traditional Rules Opposed to Exact Indemnity.*

The law reports are full of cases in which a traditional measure of damages has been applied without reference to its applicability to the particular fact situation. For example,[41] a farmer purchased mulberry trees that were lost by the defendant carrier while in transit to the farm. It later appeared that the trees were so defective as to be worthless except perhaps for the purpose of resale to someone unaware of their defects. The court awarded the market value at the time of the loss, which was considerable. Here the award of a substantial amount, not necessarily the full market value, might *possibly* be reconciled with the indemnity principle on the theory that the farmer might have sold the trees before their "worthlessness" became known. Suppose, however, that the farmer had made a contractual agreement to sell the trees at far less than market value, provided they should reach their destination. Under these circumstances the loss of the trees would not mean the loss of the market value to this farmer. Yet a traditional award would ignore this circumstance.[42]

In one case,[43] a seller failed to deliver material to a manufacturer at a time when the current selling price of similar material was higher than the market price of the finished product. The seller offered to show that the manufacturer would have been compelled to sell the finished product at a large loss, but the court held that the ordinary rule of damages would apply.

The Influence on the Value Concept of Three Conflicting Legal Motives.

A study of valuation under the law of damages is in large measure a study of the manner in which the accepted concepts of value are influenced, on the one hand by the objective of indemnity and on the other hand by those often conflicting rules or principles set forth in the preceding subsections. But perhaps the most confusing aspect of this study is to be found in the interplay of three traditionally sanctioned "judicial motives": (*a*) the desire to grant indemnity, but no more than indemnity, for the full loss unavoidably resulting from the defendant's wrongful act; (*b*) the desire *not* to hold the defendant liable for those unexpected or extraordinary losses that were men-

[41] Smith v. Griffith, 3 Hill 333 (N.Y. Sup. Ct., 1842).

[42] Contrast U.S. v. Burton Coal Co., 273 U.S. 337 (1927), discussed *infra* p. 306, with Magnin v. Dinsmore, 62 N.Y. 35 (1875).

[43] Michigan Lubrication Co. v. Ontario Cartridge Co., 275 Fed. 902 (C.C.A. 6th, 1921).

tioned in item 7 of the previous subsections; and (*c*) the desire to apply a fairly simple, objective measure of damages, which can be administered by a jury and which will expedite the trial. All three of these, often conflicting, motives may be pulling at the judge who conducts the trial; and when they do so, the outcome of the tug of war is difficult to predict. A study of the cases reveals their influence but fails to disclose their relative force.

The effect of the "full-indemnity" motive is often disclosed by the judicial rulings on valuation. Thus, in cases where the plaintiff is a retail dealer, courts, with the express object of "making the plaintiff whole," will construe "value" now in the sense of buying price, now in the sense of selling price; or they will award a wholesale buying price in one case and a retail buying price in another.[44] And thus, in a secondhand-clothing case where the plaintiff is a *user*, a court may refuse to identify "value" with secondhand-market price, although that is the price which it would probably award if the same clothing had been taken from a *dealer*.[45]

The influence of the judicial desire to secure simple and objective measures of damages is likewise obvious, particularly in those cases in which a court follows some traditional rule, such as "difference between contract price and market value," despite its admission or lack of denial that, under the facts of the particular case, the resulting award will overindemnify the plaintiff for his loss.[46] It may well be that these "rigid-rule" decisions are on the wane, under the influence of recent opinions by distinguished appellate courts.[47] However this may be, they cannot be ignored in the present stage of the law of damages.

Finally, the rule in *Hadley v. Baxendale* and the analogous "doctrine of proximate causation" have also influenced the judicial value concepts. They explain in part the use of "market value" as the assumed basis of valuation in the ordinary run of the cases, and the refusal to accept the alternative standard of "value to the owner" or "to the plaintiff" except under somewhat unusual circumstances. The adop-

[44] See the subsection of this chapter on The Dealer as Plaintiff.

[45] See Chap. XIV, subsection on Secondhand Consumers' Goods.

[46] In addition to the cases cited in the preceding subsection, compare the fire-insurance cases refusing to recognize extraordinary obsolescence (*infra* pp. 384–389); and the eminent-domain cases in which property, though clearly not worth replacing, has been valued at replacement cost minus a conventional allowance for depreciation (*infra* p. 431).

[47] See, for example, Illinois Central R.R. v. Crail, 281 U.S. 57 (1930), discussed *infra* pp. 300–301. *Cf.* McAnarney v. Newark Fire Ins. Co., 247 N.Y. 176, 159 N.E. 902 (1928), discussed *infra* pp. 389–392.

tion of this latter standard, while required by a principle of complete indemnity, would involve an allowance for the very types of loss that may be held non-recoverable under each of the two doctrines just mentioned. "Value of the property" is therefore used, not merely as a measure of the plaintiff's loss, but also as a device by which to cut the plaintiff off from a recovery for those losses for which the court does not care to hold the defendant responsible.

If the courts had adhered to some single meaning of "value" throughout the law of damages, or even if they had been consistent in their choice of occasions on which to shift its meaning, they might have found the value concept a fairly precise instrument by which to draw the line of demarcation between "general damages," which are almost invariably recoverable, and "special damages," which are recoverable only under severe limitations. In fact, however, this line has been blurred because of the willingness of some courts, but not of others, to extend the value concept itself so as to make the award of *general* damages cover the plaintiff's entire loss. Thus, in actions by dealers to recover damages for the loss or nondelivery of merchandise, some courts have declared that the merchandise must always be valued at the dealer's replacement cost rather than at his higher, selling price, since the higher valuation would include an allowance for loss of profits—a loss recoverable, if at all, only under the rubric of "special damages."[48] But other courts, apparently with the object of making the award of *general* damages cover the plaintiff's entire loss, have occasionally identified "market value," in form or in effect, with the dealer's resale price, including his regular markup.[49]

This inconsistency in the rulings on valuation, which is especially notable in the contract cases, is probably a symptom of a vain struggle by the courts to abide by two traditional rules or doctrines that are assumed to be in harmony with each other but that, in fact, are irreconcilable: (*a*) the rule that the plaintiff may recover "general damages" based on the market value of the property; and (*b*) the doctrine in the law of contract that he may recover for those losses, but *only* for those losses, that were within the reasonable contemplation of the parties at the time when the contract was made. These rules can be reconciled only on the assumption that losses due to changes in market price are invariably contemplated, whereas other losses are not

[48] See the later subsection, on The Dealer as Plaintiff; especially the remark of Judge Lehman quoted at p. 294.

[49] See the later subsection, on The Dealer as Plaintiff; especially the cases cited in notes 56, 68, 69, 74, and 76. Compare the fire-insurance cases cited *infra* pp. 373–379.

contemplated unless the defendant is put on notice or has some other special reason to anticipate the likelihood of their occurrence in the event of his breach of the contract.

Needless to say, any such assumption is either fallacious or else is a deliberate fiction. Some of the most extraordinary and most unpredictable losses resulting from breaches of contract are those due to unusual changes in market price.[50] On the other hand, one of the most "normal" and most predictable types of loss resulting from a breach is the "incidental expense" or loss of sales imposed upon a businessman by a failure to receive a shipment of goods on *the promised date of delivery.* No doubt the courts are aware of this fact and are also aware of the resulting clash between the two above-mentioned rules for measuring damages. But they are not in agreement as to which horn of the dilemma should be chosen; and hence they are not always in agreement as to the applicable standard of value.

III. Value as Dependent on Who Is Suing.

In the overwhelming majority of damage cases, "market value" has been accepted as the standard of valuation, to be departed from only "where there is no market value."[51] But in Chap. III, which discusses the meaning of "market value," we noted the serious ambiguity of the question, What is the market value of this property? when asked without stipulation as to the nature of the market in which the property might be offered for sale. Even a decision as to the precise time and place of valuation does not settle this issue, since it says nothing as to the choice between a manufacturer's selling price, a wholesaler's selling price, a retailer's selling price, and a consumer's resale price. To be sure, some of the formal definitions of market value that appear in the economic textbooks imply that market value *means* the price at which the commodity could be sold by the particular person who happens now to own it or otherwise to have the legal power to sell it. But even the economists who give this definition seldom adhere to it literally in the development of their theories; and the courts have by no means restricted themselves in this manner. Indeed,

[50] Hence the law has made it easier for a dealer to recover for the loss of those speculative profits that he makes in the role of a trader, than to recover for the loss of the regular "markup" profits that he makes in the role of a merchant!

We have found only one case limiting the plaintiff's recovery to less than breach-day market prices because the rise in prices was extraordinary and unexpected: Ducas v. Bayer & Co., 163 N.Y. Supp. 32 (Sup. Ct., 1916), in which a wholesaler sued for nondelivery of German dyestuffs rendered unprocurable because of the World War.

[51] Sedgwick, *Damages*, Vol. I, pp. 489 *et seq.*, especially 495.

with respect to chattels as distinct from real property, the courts have perhaps more frequently identified market value with the owner's replacement cost than with the price at which the owner could sell his property.

Because most of the damage cases have been concerned with merchandise and other chattels, they have given rise to more controversy as to the choice of the pertinent market than have the cases in any other field of law. In large measure, the decision on this point has depended on the business character of the person who is suing for recovery—whether he is a manufacturer, a wholesale or retail dealer, or a user. Hence we make our primary classification of the cases on this basis, although no similar major classification is used in the chapters on valuation for other legal purposes, save for the chapter on value as a measure of recovery for fire-insurance losses.

A. The Dealer as Plaintiff.

This subsection considers those cases in which the plaintiff appears in the role of a wholesale or retail dealer who has established a claim to recover damages for the loss, nondelivery, or nonacceptance of merchandise. The distinctive feature of these cases is the coexistence of two "market prices," either of which might plausibly be chosen as the basis of appraisal—the price in the market in which the dealer buys, and the higher price in the market in which he sells.

But a distinction must be drawn between those cases in which the dealer is suing a vendor for a breach of contract to deliver goods, or in which he is suing a tort-feasor for the destruction or conversion of his goods, and those other cases in which he is suing a purchaser for a breach of contract to accept the goods. As between these two situations the rules of valuation differ materially, although this difference is concealed by the traditional use of "market value" as applicable in both instances. Broadly speaking, "market value" refers to the dealer's *buying* price in the first instance, and to his *selling* price in the second instance. We shall therefore treat the cases in the order mentioned.[52]

The *verbal* formulation of the rules for measuring damages recognizes no distinctions based on the nature of the plaintiff's business. Hence, when *any* purchaser has a claim against a vendor for breach of a contract, his usual measure of recovery is said to be the difference between contract price and market value at the time and place of the intended delivery—"difference" here meaning excess in market value over contract price. Similarly, the recovery from a tort-feasor for the loss or destruction of goods is to be measured by "market value"

[52] For the cases in which the dealer-plaintiff is a *vendor*, see *infra* pp. 303–307.

at the time and place of the wrong. But, in order to avoid circumlocution, we shall often refer even to the former rule as setting the damages at market value.

The question now to be discussed is whether "market value" here refers to the dealer's buying market, or to his selling market. This question cannot be answered by reference to the law dictionary, since the courts have frequently used the term in both senses.[53] Nor, contrary to some of the textbooks, can it always be settled by reference to the quantity of the goods involved in the claim for damages—by the choice of wholesale price for goods in wholesale quantities, and of retail price for goods in retail quantities. Established trade connections predetermine the prices at which people can buy and sell commodities, no less than do the quantities in which the deals take place; and the practice of wholesalers (and even, sometimes, of manufacturers) may permit a haberdasher to buy a single shirt at wholesale price, while denying this privilege to a retail customer.

The *general rule* is that "market value" here refers to the dealer's *buying* price. In effect, this means that the dealer recovers his ordinary replacement cost, with no allowance for "markup." Indeed, some courts have referred to replacement cost as, *per se*, the measure of damages, although other courts have referred to it as mere "evidence" of an undefined "market value."

Consistently with this tendency to identify "market value" with replacement cost, courts have held that, where a vendor has broken his contract to deliver goods, and where there was no market for these goods at the stipulated time and place of delivery, the dealer may recover their value in the nearest available market *plus* transportation costs[54]—a measure of damages that hardly makes sense except as a device whereby to award the dealer his full replacement cost.

The valuation of goods at the dealer's buying price is sometimes defended on the ground that any higher valuation would include an allowance for loss of profits. In the words of Justice (now Judge) Lehman,

[53] See *supra* pp. 61–62.

[54] Grand Tower Co. v. Phillips, 90 U.S. 471 (1874). Contrast the suits for breach of contract to *accept* merchandise, where recovery may be based on the selling price in the nearest available market, *minus* the vendor's costs of shipping the goods to that market. Even where the plaintiff is a purchaser, but where, contrary to the usual rule, the undelivered merchandise is valued by reference to his *selling* price, a court may arrive at this price by taking the price in the market in which the dealer was accustomed to sell *minus* costs of transportation from the point of promised delivery. Sedgwick, *Damages*, Vol. II, p. 1545.

The market price which determines the plaintiffs' loss is the general market price at which they could have bought the material. The special market price at which the plaintiffs can sell would determine their loss of profits only, and loss of profits cannot be shown as general damages.[55]

Remarks of this nature clearly require restatement in order to make them accurate even on their face; for an award of "general damages" based on an excess of replacement cost over contract price is just as much a recovery for loss of profits as would be an award that includes an allowance for the dealer's regular markup. But even aside from this verbal inaccuracy, the doctrine denying general damages for loss of profits does not constitute the most plausible defense of a valuation limited to replacement cost. The better defense, and the one often made by the courts, is that the dealer, by a prompt replacement of the goods, might have limited his loss to the cost of this replacement (or to that cost minus contract price). The plaintiff is therefore denied recovery for any further loss of profits because he did not in fact lose them, or else because he *need* not have lost them.

This legal rule under which merchandise owned by, or destined for, a dealer may not be valued in excess of the dealer's replacement cost, is a practical application of the appraiser's maxim discussed in Chap. IX—the maxim that replacement cost sets the usual upper limit of the value of replaceable property. But, as that chapter pointed out, this maxim is not strictly valid when stated in so crude a form; and on many occasions its unqualified acceptance would lead to a serious undervaluation.

Needless to say, the maxim is inapplicable to property that is utterly irreplaceable, or even (without modification) to property that could be replaced only with an inferior substitute. Moreover, it does not apply to property that could be replaced only after a delay so critical that the substitution would not be worth making. But it does not even apply, without modification, to property which the owner would rationally replace, but which he could not replace in time to avoid material loss as a result of the delay. Here, the replacement cost will not measure the full value of the property to the owner unless an additional allowance is made for the immediate availability.

Turning now to the reported cases, we find that in the "strictly unique" merchandise cases, as where a vendor has broken his contract to deliver a patented article, the courts have treated the property as "irreplaceable" and have upheld awards based on a "value to the

[55] Foster v. Hudson Wrecking & Lumber Co., 74 Misc. 420 at 422, 134 N.Y. Supp. 34 at 36 (Sup. Ct., 1911). See also O'Gara v. Ellsworth, 85 App. Div. 216, 83 N.Y. Supp. 120 (3d Dept., 1903).

owner" measured by probable sale price.[56] It has even been suggested that substitute merchandise of another trademark, although "equally good," may be found not to constitute an adequate replacement.[57] But the holding on this point may turn on the question whether, under the doctrine in *Hadley v. Baxendale*, the vendor was on notice that goods of the specified trademark were required by the purchaser.[58]

Cases in which the opinion makes it clear that the merchandise might eventually have been replaced, but only after a delay that would have rendered the replacement utterly futile, are by no means so numerous as might be expected. However, those cases most nearly in point justify the inference that, here too, the property would be deemed "irreplaceable" and that a court would sanction an award based either directly on loss of profits or else on a "value" measured by the plaintiff's selling price.[59] This statement, however, may require qualification in the event that the dealer's need for immediate availability could not fairly have been anticipated by the vendor. Here, the rule in *Hadley v. Baxendale* (and perhaps the doctrine of proximate causation) might be invoked against a recovery in excess of the cost of replacement within a conventionally "reasonable" period of time.

More troublesome are those borderline cases in which the dealer did or could mitigate his damage by timely replacement, but only after a delay resulting in a non-recapturable loss of sales, or in some other "incidental" loss. Here, most cases have limited general damages to a "value" measured by replacement cost, leaving the plaintiff free to claim additional, special damages, subject to the familiar legal restrictions against a recovery of this nature.[60] But a few of the cases suggest that merchandise may be *valued* at the dealer's selling price whenever the unavoidable delay in replacement has imposed upon the dealer a provably serious loss of sales.[61] And still other cases, while nominally

[56] Ideal Wrench Co. v. Garvin Machine Co., 92 App. Div. 187, 87 N.Y. Supp. 41 (1st Dept., 1904); Neverfail Lighter Co. v. Blum, 201 App. Div. 153, 194 N.Y. Supp. 24 (1st Dept., 1922). *Cf.* Wade v. Herndl, 127 Wis. 544, 107 N.W. 4 (1906) (artist's own work destroyed).

[57] Orester v. Dayton Rubber Mfg. Co., 228 N.Y. 134, 126 N.E. 510 (1920), discussed below.

[58] Czarnikow-Rionda Co. v. Federal Sugar Refining Co., 255 N.Y. 33, 173 N.E. 913 (1930); *cf.* Pope v. Ferguson, 82 N.J.L. 566, 83 Atl. 353 (1912).

[59] See Gilman v. Broad Brook Co., 137 Misc. 685, 243 N. Y. Supp. 312 (Sup. Ct., 1930); Jordan, Marsh & Co. v. Patterson, 67 Conn. 473, 25 Atl. 521 (1891), discussed below.

[60] *E.g.*, Thorn & Morgan v. Whately Co., 135 Mich. 51, 97 N.W. 43 (1903); Vickery v. McCormick, 117 Ind. 594, 20 N.E. 495 (1889).

[61] See, for example, Trigg v. Clay, 88 Va. 330, 13 S.E. 434 (1891); Jordan, Marsh & Co. v. Patterson, *supra* note 59.

limiting general damages to replacement cost, have identified this very cost, in effect, with the dealer's selling price whenever the dealer himself could have expeditiously replaced only at such a price.[62]

A brief review of typical cases is now in order. But most of the opinions leave unanswered certain important questions of fact bearing on the nature and amount of the loss due to the plaintiff's inability to make immediate replacement. For this reason, it is often impossible to determine the degree of consistency between the accepted measure of damages and the declared objective of indemnity.

Wehle v. Haviland,[63] decided by the New York Court of Appeals, illustrates the usual rule in favor of a valuation based on the dealer's buying price rather than his selling price. The plaintiff's merchandise had been wrongfully seized by the sheriff, and the trial court had permitted the jury to measure damages at "retail value." On a prior appeal,[64] this ruling seems to have been upheld by the high court, which declared: "The plaintiff was plainly entitled to recover, as part of her damages, the fair retail value of the goods unlawfully taken." But, on the later appeal, the court changed its position and reversed the judgment, saying:

> The plaintiff was entitled to recover so much as would repair the injury sustained by the wrong-doing of the defendants, and that was the money value of the goods at the time and interest thereon. But money value is the price for which they could be replaced for money in the market.

This opinion reveals the frequent assumption that replacement cost is in fact "so much as would repair the injury sustained by the wrongdoing of the defendants."[65] To be sure, the court sees quite clearly what is wrong with the jury's award:

> The retail value or the price at which goods are sold at retail includes the expected and contingent profits, the earning of which involves labor, loss of time and expenses, supposes no damage to or depreciation in the value of the

[62] See Wilmoth v. Hamilton, 127 Fed. 48 (C.C.A. 3d, 1904), discussed below. Compare the cases cited *infra* notes 74, 76, 77.

[63] 69 N.Y. 448 (1877).

[64] Wehle v. Butler, 61 N.Y. 245 (1874). *Cf.* Kilpatrick v. Whitmer & Sons, 118 App. Div. 98, 103 N.Y. Supp. 75 (1st Dept., 1907), where evidence of retail price was excluded.

[65] Another passage from the opinion reads: "The sum at which the plaintiff could have replaced the goods in the market would have indemnified her for the loss sustained, and the interest upon that sum would have given her the legal profit to which she was entitled, the fixed legal rate of interest taking the place of the uncertain and indefinite profits which the plaintiff might have made either from the possession of the goods or their equivalent in money." 69 N.Y. at 450–451.

goods, and is dependent upon the contingency of finding purchasers for cash, and not upon credit, within a reasonable time, the sale of the entire stock without the loss by unsaleable remnants, and the closing out of a stock of goods as none ever was, or ever will be closed out, by sales at retail at full price.

It does not follow, however, that because the rejected measure may overcompensate, the accepted measure necessarily compensates. It is not even clear that the jury's award did overcompensate, because possible loss of good will and overhead expense might have injured the plaintiff beyond the amount awarded.

In a case of this type, most courts would probably follow the view that replacement cost represents the value or the market value.[66] There is, however, a tendency, shared by the lower New York courts,[67] to make an additional allowance for interruption of business or demonstrable loss of sales where the entire stock of merchandise has been seized or destroyed. Such damage is difficult of proof. Even from the standpoint of strict replacement cost, consideration might will be given to the labor and expense of selecting, collecting, storing, and displaying the merchandise.

In *Wehle v. Haviland*, as in most of the other cases requiring a valuation based on replacement cost, the opinion fails to indicate whether or not the plaintiff suffered "incidental" losses resulting from delayed replacement. But in *Jordan, Marsh & Co. v. Patterson*,[68] the seriousness of such a delay was accepted as a ground, partly for a direct recovery for loss of profits, and partly for a *valuation* at retail selling price. There, a dry-goods merchant sued a manufacturer of knit underwear for failure to deliver 1,000 gross, which could not be replaced on the market in time to meet seasonal demand. When the underwear was ordered, some of it had already been resold, and the defendant was informed of these sales; the remainder was sold thereafter. The court held that as to the resales antedating the order, the profit actually

[66] For an attempt to cling to "market value" without accepting either replacement cost or selling price, see Needham Piano & Organ Co. v. Hollingsworth, 91 Tex. 49, 40 S.W. 787 (1897), which sanctions *bulk* selling price. City of Paris v. Baldwin Bros., 169 Ky. 802, 185 S.W. 144 (1916), contains a statement that the selling price is the market price; but this appears to be mere dictum, since the judgment affirmed seems to have been based on replacement cost.

[67] Such an award has been made for a considerable period of time in *trespass* actions; see B. B. Clark, *New York Law of Damages*, Vol. I, (Northport, N.Y., 1925), pp. 143–144. In a conversion action such recovery was denied in Montignani v. E. V. Crandall Co., 34 App. Div. 228, 54 N.Y. Supp. 517 (2d Dept., 1898); see, however, Ebenreitter v. Dahlman, 18 Misc. 351, 41 N.Y. Supp. 559 (City Ct., 1896), *aff'd*, 19 Misc. 9, 42 N.Y. Supp. 867 (Sup. Ct., 1896); Schile v Brockhahus, 80 N.Y. 614 (1880).

[68] 67 Conn. 473, 35 Atl. 521 (1896).

lost was conclusive as a measure of recovery. It further held that the profit on the later sales could be introduced into evidence, since

. . . they [the defendants] were chargeable with knowledge that the plaintiffs would make such profits as the market price of such goods would give them. If proof of the terms of these last-mentioned subsales was offered for the purpose of showing what the market price of such goods was at the time they were to be delivered, then the evidence should have been received. The market value of any goods may be shown by actual sales in the way of ordinary business.

In *Trigg v. Clay*,[69] the plaintiff-dealer, after contracting to buy lumber from the defendant, resold it at an advance of $1,000. The defendant failed to perform, and immediate replacement was impossible. The commissioner before whom the case was tried awarded the $1,000 lost profits, as such. The first appellate court reversed, holding that the defendant was not liable for a lost profit, since he had no notice of intended resale *when contracting*. The verdict was, however, reinstated by the higher court. It disagreed with the lower court's interpretation of the *Hadley v. Baxendale* rule, as applied to a plaintiff known by the seller to be a dealer. But it based its decision principally upon the ground that, where immediate replacement is impossible, there is no *market* value, and hence that the resale price is evidence of "value" within the meaning of the rule that a buyer recovers the difference between the value and the contract price:

In a case like this, with such circumstances as we have here, the case where there had been a contract to resell them at an agreed price, and when there is no market to afford a surer test, the price at which they were bargained to a purchaser affords the best and indeed very satisfactory evidence of their value. This was a purchase in that market, and there was no more for sale. In a case of such actual sale, why should the court go into conjecture as to what the goods were there worth?

The court also cited a textbook on damages,[70] which stated the following rule:

But if they [the goods] cannot be purchased for want of a market, their value must be estimated in some other way. If there has been a contract to resell them, the price at which such contract was made will be evidence of their value.

[69] 88 Va. 330, 13 S.E. 434 (1891).

[70] H. G. Wood's *Mayne on Damages* (3d Eng. & 1st Amer. ed., Albany, N.Y., 1880), p. 28.

An award of damages intermediate between that measured by replacement cost and that measured by resale price was suggested by the New York Court of Appeals in *Orester v. Dayton Rubber Manufacturing Co.*[71] Here, the defendant, a rubber-tire manufacturer, had failed to deliver 1,000 tires to the plaintiff, a dealer to whom he had given an exclusive selling privilege within the territory, under an agreement whereby the dealer was to buy the tires below their list price. The lower court had permitted the jury to award the difference between contract price and a "market price" equal to the dealer's resale price. This was held error, as giving the dealer full credit for a *gross* profit that he could have realized only if he had sold all of the tires, and only after incurring further selling expenses. But, while stating that the ordinary measure of damages would be the cost of replacing the goods in like quantity, the Court of Appeals added that, if the tires were found to be "irreplaceable," the plaintiff might then recover "the value of his contract" as measured by his loss of *net* profits, "if reasonably certain." Moreover, it intimated that these tires might properly be deemed "irreplaceable" if tires of some other trademark, while "equally as good," would not have constituted a "satisfactory substitute" from the dealer's standpoint.

Culin v. Woodbury Glass Works[72] is of interest for its award based on replacement cost for a part of the goods, and on loss of profits for the other part. The seller had failed to deliver a supply of bottles ordered by the dealer. Although the dealer had succeeded in replacing a part of this supply, at an advance over the contract price, he was unable to secure the balance. The seller was willing to compensate him for the entire lot at the price at which he replaced the part. But the court held that, as to the balance, the dealer was entitled to recover his entire loss of profits.

An example of a case abandoning completely the test of "value" in favor of the test of lost profits is *Messmore v. New York Shot & Lead Co.*[73] The plaintiff had a contract with the state of Ohio to supply it, at 7¾ cents a pound, with bullets which the defendant undertook to deliver at 7 cents a pound. When performance was due, the defendant failed to deliver, and similar bullets could not be purchased in time for redelivery. The plaintiff sued for the profits he would have made, and recovered. This is the strongest type of case for a plaintiff-dealer, since the defendant had been given full information as to the intended resale, and since the lost profits were definite in amount.

[71] 228 N.Y. 134, 126 N.E. 510 (1920).
[72] 108 Pa. 220 (1885),
[73] 40 N.Y. 422 (1869).

But where the defendant, although on notice of the resale, is not informed of the price, he will be liable only for the usual selling advance, as shown by normal resale market prices.

We may now take note of cases in which the choice between two simultaneous "market prices" takes the verbal form, at least, of a choice between alternative replacement prices, rather than between a buying price and a selling price. In *Wilmoth v. Hamilton*,[74] a retail coal dealer, who had been buying directly from a mine, sued the mine-owner for a breach of his contract to deliver coal and asserted that he was unable to secure substitute coal from other mines. Under these circumstances, said the court, the plaintiff's replacement cost was the cost of purchasing coal from other dealers. But one suspects that what the court was really awarding was the dealer's selling price. While retailers sometimes make good an unexpected shortage through purchase from other retailers, the practice is relatively infrequent and is often discouraged by the rules of the trade.

It is often said that the choice between a retail-replacement cost and a wholesale-replacement cost is definitely settled by reference to the *quantity* of goods involved in the valuation: a wholesale quantity must be valued at wholesale price; a retail quantity, at retail price. Indeed, some of the cases seem to have applied this rule mechanically.[75] But other cases have followed a more flexible procedure, by awarding whatever price the plaintiff was under constraint to pay in order to minimize his loss.[76]

Faced with this issue in *Illinois Central R.R. v. Crail*,[77] the Supreme Court preferred the more flexible rule. Here, a Minneapolis coal dealer had bought a carload of coal weighing 88,700 pounds and, on its delivery at his railroad siding, had discovered a shortage of 5,500 pounds. The railroad, having been held liable for the loss, contended that damages should be based merely on carload-lot value per pound, since the plaintiff had actually replaced at this price, having been under

[74] 127 Fed. 48 (C.C.A. 3d, 1904).

[75] In Illinois Central R.R. v. Crail, presently to be mentioned, two cases were cited by counsel as supporting the inflexible rule: Heidritter Lumber Co. v. Central R.R., 1 N.J. Misc. 185, 122 Atl. 691 (1923), *aff'd*, 100 N.J.L. 402, 125 Atl., 926 (1924); Leominster Fuel Co. v. New York, N.H. & H. R.R., 258 Mass. 149, 154 N.E. 831 (1927).

[76] Brown Coal Co. v. Illinois Central R.R., 196 Iowa 562, 192 N.W. 920 (1923). See other cases cited by Justice Stone in the Crail case, discussed presently.

[77] 281 U.S. 57 (1930). This case, like that mentioned in note 76, was decided under the so-called Cummins Amendment to the Interstate Commerce Act, providing for recovery for "actual loss." But Justice Stone indicated that the same rule would apply under the common law.

no pressure quickly to make good the small shortage. The dealer, while apparently conceding that an award of small-lot price would overindemnify him for his actual loss, nevertheless insisted on the latter award as a matter of law, and by virtue of an established rule of "convenience."

The District Court upheld the railroad; the Circuit Court of Appeals upheld the dealer; the Supreme Court reinstated the award of the District Court. Justice Stone, who spoke for the highest Court, remarked that a "valuation" of property, in a suit of this nature, is merely a device for attaining the ultimate objective—that of indemnifying the injured party for loss actually sustained. The term "value" must therefore be construed with this end in mind. In this case, the argument for a convenient, mechanical rule was beside the point; for it was just as convenient to award wholesale price as to award retail price. Referring to the rule urged by the plaintiff, that damages must be set "at the sum required to replace the exact amount of the shortage at the stipulated time and place of delivery," he said:

> As so stated, it would have been applicable here if there had been a failure to deliver the entire carload of coal, since the wholesale price, at which a full carload could have been procured at point of destination, would have afforded full compensation [citing cases], or, in some circumstances, if respondent had been under any constraint to purchase less than a carload lot to repair his loss or carry on his business, for in that event the measure of his loss would have been the retail market cost of the necessary replacement, *Haskell v. Hunter*, 23 Mich. 305, 309. But in the actual circumstances the cost of replacing the exact shortage at retail price was not the measure of the loss, since it was capable of replacement, and was, in fact, replaced in the course of respondent's business from purchases made in carload lots at wholesale market price without added expense.

The position taken by the Supreme Court in the *Crail* case, to the effect that a mechanical rule of valuation must not stand in the way of the ultimate objective of indemnity, is especially noteworthy since it is in conflict with the position previously taken by the same court in *United States v. Burton Coal Co.*,[78] discussed in a later section of this chapter.

In most of the cases so far discussed, the plaintiff's claim for an allowance in excess of ordinary replacement cost would seem to have been based on the alleged absence of a market in which the goods could have been replaced at this cost, without delay. But even if such a market existed, timely replacement might have been impossible *for the plaintiff* because of his financial inability to make the new purchase.

[78] 273 U.S. 337 (1927). See *infra* pp. 306–307.

Of course, if the claim for damages is based on a breach of a contract to deliver merchandise for which prepayment has not been made, any funds that were earmarked for the original vendor would have been available to finance the substitute purchase. But this condition would not be met if the buyer had prepaid the seller, or if his claim were for the destruction or conversion of his own property.

Oddly enough, we have not seen this issue raised either in the textbooks or in the cases coming to our attention. One may note, however, that the "fluctuating-market" rule, treated in the next chapter, is sometimes said to be designed to protect traders who may have been financially unable to make immediate replacement of the securities or commodities of which they have been wrongfully deprived.[79]

So far, we have assumed that an award of damages measured by replacement cost will err, if at all, on the side of underindemnity. But the contrary possibility should not be ignored; for the property in question may not have been "worth replacing." In the first place, the goods may have deteriorated or gone out of fashion. In the second place, the dealer may have lacked customers who would buy them at any price. Indeed, at the time of the breach or the tort he may have gone out of business, perhaps because of bankruptcy.

No doubt, the first of these two situations would receive consideration from a court.[80] But as to the second situation we can only speculate in the absence of reported cases.[81] Even the modern judges are prone to construe the "value" of property in terms of some attribute supposedly inherent in the property itself. While recognizing the more familiar forms of depreciation, they are likely to ignore any

[79] See Chap. XIV, Sec. IV*A*. The rule in some jurisdictions denying the benefit of the "fluctuating-market" rule to plaintiffs who are suing a vendor for breach of contract, unless the plaintiff has made prepayment, is in harmony with this *rationale*. See McCormick, *Handbook on the Law of Damages*, pp. 183 *et seq.*

[80] *Cf.* Grubbs v. N.C. Home Ins. Co., 108 N.C. 472, 13 S.E. 236 (1891), a fire-insurance case mentioned *infra* p. 375. If there were a market in which the dealer might buy equally unfashionable or defective merchandise, a court would be likely to accept the price in this market as the measure of value. Otherwise, it would have to choose between an award based on the probable resale value of the very goods in question, and an award based on the cost of acquiring superior substitute goods, perhaps with some allowance for the inferiority of the present goods. (But see Hinde v. Liddell, *infra* note 103.) Compare the cases cited in Chap. XIV, Subsection on Secondhand Consumers' Goods.

[81] That such factors may be influential is suggested by E. H. Taylor, Jr., & Sons v. Julius Levin Co., 274 Fed. 275 (C.C.A. 6th, 1921). Compare the bankruptcy cases in which merchandise is appraised for the purpose of determining solvency: *infra* pp. 773–775.

impairment in value associated with the peculiar circumstance of the person to whom the property *has* a value, rather than with the property as a physical object. In view of this tendency, we surmise that a court would hesitate to instruct a jury that it must award something *less* than replacement cost if it finds that the plaintiff could not have resold the goods at this price.[32]

A peculiar problem of valuation arises where the dealer accepts the promised goods but sues for *delayed* delivery. Here he may usually recover in damages any diminution in the value of the goods between the contractual and the actual dates of delivery.[83] Most of the pertinent cases do not clearly indicate whether "value" here refers to the dealer's buying price or to his resale price. But the latter choice is the more plausible one, and it was made in a case cited below.[84]

Up to this point, we have ignored the dealer-*seller* as plaintiff; *i.e.*, a suit by a dealer against a buyer who has refused to take and pay for merchandise ordered at a stipulated price. Usually, however, the seller does not seek *damages;* if the transaction is such that title to the property may be held to have passed to the buyer, the seller may sue for the entire contract price.[85] Ordinarily, moreover, he is entitled

[82] Still other circumstances than the two just mentioned might have caused the undelivered goods, had they been delivered, to be worth less to the dealer than their replacement cost at the time of the breach. A third situation is that in which the buyer, prior to the breach, had already resold the goods at less than their breach-day replacement cost, under a resale contract conditioned on his acquiring them. Here, the replacement would serve merely to keep alive what had become a bad bargain. On this point see the cases cited *infra* note 92. A fourth situation arises when the dealer, through some favorable accident, has been able to replace the undelivered goods at less than their ordinary, market-replacement cost at the time of the breach. A number of cases cited by Williston (*Sales*, Vol. II, p. 1495, n. 75) indicate that the award will here be *limited* to the cost actually incurred by the dealer in making adequate replacement. It would seem that these holdings or dicta refer to cases in which the dealer had actually replaced at a different time or place from the time or place of the breach. See, for example, Fechheimer Iron & Steel Co. v. Baress, 122 N.Y. Supp. 683 (App. Tr., 1910); Theiss v. Weiss, 166 Pa. 9, 31 Atl. 163 (1895).

[83] Sedgwick, *Damages*, Vol. II, p. 1538. As to the question whether the buyer may recover for a decline in market value even if he suffers no direct loss by virtue of the delay because he received the goods in time to complete a resale contract, see McCormick, *Handbook on the Law of Damages*, p. 669, n. 39, citing Wertheim v. Chicoutimi Pulp Co. [1911] A.C. 301; Pastor v. Lindner & Bro., 233 App. Div. 396, 253 N.Y. Supp. 184 (1931).

[84] Shepherd, Croan & Co. v. Templeman's Admin'r, 143 Ky. 334, 136 S.W. 648 (1911).

[85] Under the Uniform Sales Act, §63, he may also recover this price if the goods are not readily resalable for a reasonable price or if the payment was due on a specific date, irrespective of delivery or transfer of title.

not only to retain the property as security for the payment of the purchase price, but also to sell it for the best price obtainable, holding the buyer responsible for any deficiency.[86] In this way, he avoids the necessity for a litigated valuation and has a more effective and less hazardous remedy.

On certain occasions, however, the seller is under the necessity of suing for damages. In such a case, the usual measure of recovery is the excess, if any, of the contract price over the market value at the time of the breach.[87] But, contrary to the ordinary rule in the plaintiff-purchaser cases, "market value" seems here to mean the value in the market in which the dealer *sells*, not in which he buys.[88]

The assumption underlying this valuation at the plaintiff's selling price is that his unavoidable loss is determined by the difference between the amount that the defendant had promised to pay for the goods, and the lower amount at which the plaintiff could have sold the goods to some other buyer. But this assumption is so frequently belied in practice that its acceptance by the courts, even as a general working rule, is not easy for us to understand. It overlooks, particularly, the likelihood that the dealer's market is a limited one, with the result that his resale of the rejected goods would encroach on his opportunity to sell other goods.

Consider, for example, the case of a Ford or Buick dealer who is seeking damages for a breach of his customer's contract to buy a car. Under the rule as stated above, the dealer could recover no damages whatever unless the prevailing retail price of the car had been reduced between the time when the contract was entered into and the time of the breach. Ordinarily, an automobile dealer is able to secure from the manufacturer as many cars as he can sell, and the failure of the defendant to take the car contracted for is not made good by another sale.

The same situation would normally exist in the case of a breach by a dealer of his contract with the *manufacturer* of the motor car, or of radios, victrolas, plum puddings, and steel rails, where standard prices prevail. Nor can the situation be met by a sale, at a lower price, of the quantity involved in the contract, to a person who would not otherwise be a customer. The injury to good will that might result from such a sale, assuming that a buyer could be found without incurring disproportionate expense, would be an effective deterrent. But even if resort were had to the sale, the original purchaser might well argue

[86] Uniform Sales Act §§53, 55, 60.
[87] Sedgwick, *Damages*, Vol. II, pp. 1570–1575.
[88] Kittle v. Huntley, 67 Hun 617, 22 N.Y. Supp. 519 (Sup. Ct., 1893).

that it was the sale prices of the many, rather than the sale price of the one, which represented the market value of the article in question. In view of the extraordinarily large number of manufacturers and dealers who are subject to the foregoing considerations, it is surprising that so little judicial discussion of them has been found.[89]

[89] The leading case for allowing the loss of bargain is Torkomian v. Russell 90 Conn. 481, 97 Atl. 760 (1916), where the court said that the market-value rule is "not an unbending one, that the circumstances may require its modification in order to effectuate the cardinal purpose, 'just compensation for the loss incurred.'" This case was followed in Stewart v. Hansen, 62 Utah 281, 218 Pac. 959 (1923). But the Connecticut court retreated in the analogous case of Sabas v. Gregory, 91 Conn. 26, 98 Atl. 293 (1916), without even citing its earlier decision.

In New York, there appear to be only two decisions. In the earlier, Poppenburg v. Owen & Co., 84 Misc. 126, 146 N.Y. Supp. 478 (Sup. Ct., 1914), *aff'd*, 165 App. Div. 946, 150 N.Y. Supp. 1107 (4th Dept., 1914), *aff'd*, 221 N.Y. 569, 116 N.E. 1070 (1917), a sole distributor of Reo cars, at fixed prices, sued a sub-distributor for certain counties, for failure to order the number of cars specified in his contract. The court instructed the jury to award the difference in the two prices, on the ingenious ground that there was no market price because the general agent fixed the market price himself. But in Lowas Garage Co. v. Scheer, 199 N.Y. Supp. 748 (1923), the court refused to apply the same rule to a suit by an ordinary dealer against a customer. One judge dissented.

Even the courts which favor the seller in this type of case are reluctant to allow this measure of damages in the case of sales on commissions; see Note, 44 A.L.R. 349 (1926).

The courts are more liberal in the cases where the plaintiff is a manufacturer, as implied by Poppenburg v. Owen & Co., discussed above, where the court said that the sole distributor was practically in the same position as the manufacturer. Pratt v. Auto Spring Repairer Co., 196 Fed. 495 (C.C.A. 1st, 1912). But *cf.* Crane Iron Works v. Cox & Sons Co., 28 F. (2d) 328 (C.C.A. 3d, 1928); see also, Hemingway Manufacturing Co. v. Council Bluffs Canning Co., 62 Fed. 897 (C.C.S.D. Iowa, 1893).

Another case with ingenious reasoning is Kingman & Co. v. Hanna Wagon Co., 176 Ill. 545, 52 N.E. 328 (1898), where the buyer-defendant undertook to use the plaintiff-manufacturer's entire product. A recovery for the loss of bargain was held justified because plaintiff did not sell to others and hence there was no market price for its products.

On the whole, the most fortunate plaintiff in this type of case is the manufacturer who has not made up the product, because he is generally permitted to recover the difference between the cost of manufacture and the price agreed upon. Hinckley v. Pittsburgh Steel Co., 121 U.S. 264 (1887), is a leading case. The manufacturers' cases are mentioned here because this special situation is not discussed in the section dealing with manufacturers. For the problem of overhead costs in this connection, see McCormick, *Handbook on the Law of Damages*, pp. 661–662.

One bold plaintiff, on the buyer's refusal to accept a shipment of automobiles, sold the cars in job lots at the buyer's town, so as to dissociate the resulting prices from his regular price for his product. The court reluctantly awarded the difference between the contract price and the amount realized. Rudolph v. Laser. 156

On the other hand, the usual measure of recovery has been applied even when it seems to have been far in excess of the loss sustained. In *United States v. Burton Coal Co.*,[90] the plaintiff had agreed to sell coal to the government at $6.75 per ton. He had also made arrangements to buy for slightly below this figure, reserving the privilege of cancellation on nonperformance by the government. At the time of breach, the resale price of the coal had fallen to $4.60 per ton. The government contended that its breach of contract had cost the plaintiff only a few cents per ton, namely, the difference between the prices specified in the two contracts. But the Supreme Court held that the plaintiff was entitled to $2.15 per ton, stating:

> The applicable measure of damages is fixed by the rule of law that, where a buyer in violation of an executory contract of sale refuses to accept the commodity sold, the seller may recover the difference between the contract price and the market value at the times when and places where deliveries should have been made. . . . The facts brought forward by appellant do not take the case out of the general rule. . . . The difference between that value and the contract price is the amount of damage deemed by the law directly and naturally to result in the ordinary course of events from the appellant's breach of contract. The cost to appellee of securing the coal and the amount of its profits are immaterial.[91]

This opinion is reminiscent of *Wehle v. Haviland*, already discussed. The court is conscious that the award does not measure the loss actually

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Ark. 5, 245 S.W. 302 (1922). In the somewhat analogous situation of advertising contracts, it has been held that the advertising agent need not relet the vacant space at less than regular rates. Barron G. Collier, Inc. v. Kindy, 146 Minn. 279, 178 N.W. 584 (1920). Nor need he make special efforts to induce his customers to take this space rather than other space. Ware Bros. Co. v. Cortland Cart & Carriage Co., 210 N.Y. 122, 103 N.E. 890 (1913). It might be argued that he was entitled to try to sell other space rather than defaulted space; but here the courts are unwilling to follow what may be the ultimate logic of their reasoning.

The most recent case on this point is Wilhelm Lubrication Co. v. Brattrud, 268 N.W. 634 (1936), in which the Supreme Court of Minnesota allowed recovery for loss of bargain to a compounder and wholesaler of oil and grease.

[90] 273 U.S. 337 (1927).

[91] 273 U.S. at 337–338. *Cf.* Foglino v. Webster, 244 N.Y. 516, 155 N.E. 878 (1926), *rev'g* 217 App. Div. 282, 216 N.Y. Supp. 225 (1st Dept., 1926), an action for nonacceptance of 15,000 tons of coal. Here the seller's supplying contract was unconditional, but the supplier voluntarily agreed to abrogate it on learning of the sub-vendee's breach. The court overthrew an award based merely on the difference between the two contract prices, stating that the traditional measure should govern, and disregarded the voluntary release since "the rule to be adopted does not vary because of the generosity of third parties." But see Booth v. Milliken, 127 App. Div. 522, 111 N.Y. Supp. 641 (1st Dept., 1922).

sustained. But because it is the traditional award, which the courts have held "as a matter of law" to be the measure of the loss, it is to be granted in all cases where by its terms it is applicable, regardless of the question whether in the particular case the plaintiff receives too little or too much.

With the *Burton* case should be compared the decision of the Wisconsin court in *Foss v. Heineman,*[92] where the plaintiff-buyer had contracted with the defendant to purchase his entire output, and was under contract with a third party to resell at a stated price all the property he might obtain. The difference between replacement cost and contract price was greater than the profit which the plaintiff would have made if the defendant had performed. The court awarded the latter, stating that it saw no reason why the plaintiff should recover more than he had in fact lost.

Problems of evidence or proof of value, in actions by dealers, present little of interest to the student of valuation. As we have seen, the controversy has been largely confined to the choice of the pertinent market. In order to establish "market values," in the sense of replacement prices, the courts require a showing that there were sales in that market at or near the time and place in question. Current sales of similar property would therefore be admissible in evidence for the double purpose of showing the existence of a market and the prevailing prices.[93]

In the case of commodities or securities traded in on ordinary exchanges, the lists of transactions published in trade journals are uniformly admitted when it is shown that they are relied upon by the

[92] 144 Wis. 146, N.W. 881 (1910). The same result was reached in two cases where the resale contract was unconditional, but where the sub-vendee voluntarily released the vendee from liability under it. Texas Co. v. Pensacola Maritime Co., 279 Fed. 19 (C.C.A. Fla., 1922); Kaye v. Eddystone Ammunition Corp., 250 Fed. 654 (E.D. Pa., 1918). Contrast the position taken as to the converse situation in Foglino v. Webster, *supra* note 91. Ordinarily, where there is an unconditional resale contract, the plaintiff is deemed to be under compulsion to replace in order to save himself from the hazards of a lawsuit, and is thus not restricted to lost profits. Tennessee Fertilizer Co. v. International Lumber Corp., 146 Tenn. 451, 243 S.W. 81 (1921); Floyd v. Mann, 146 Mich. 356, 109 N.W. 679 (1906). In sharp contrast to these cases is the English view, which apparently ignores the resale contract on the ground that value must be ascertained "independently of any circumstances peculiar to the plaintiff": Rodocanachi v. Milburn, 18 Q.B.D. 67 (1886); Williams Brothers v. E. T. Agius, Ltd. [1914], A.C. 510.

[93] Pacific Telephone & Telegraph Company v. Huetter, 68 Wash. 442, 123 Pac. 607 (1912); Haskell v. Hunter, 23 Mich. 305 (1871); Goldstein v. Arkell & Douglas, 164 N.Y. Supp. 580 (Sup. Ct., 1917). See Wigmore, *Evidence*, Vol. I (2d ed., Boston, 1923) §§463–464.

trade as setting forth accurately current transactions.[94] There are cases holding that such proof is decisive as to actual sales of the same or similar property and not only satisfies the requirement of proof but bars testimony of transactions not within the same price range.[95] Where, however, the market is not both well organized and highly active, the reported sales, while admissible, are no longer conclusive[96].

When the merchandise is not of the type just discussed, value will be shown either by expert testimony, that is, by the testimony of other dealers or of the plaintiff himself, or by testimony of actual transactions, which may be given by anyone who was a party to them. It is necessary that the goods concerning which testimony is offered be similar to the goods involved in the litigation. In expert testimony, the witness purports to value the very property in question. But on cross-examination, counsel may undertake to discredit the testimony by showing that the expert is relying for his conclusion upon sales of dissimilar property.[97] Prices at which the plaintiff actually replaced,[98] or sold at public sale,[99] are favorably received.

[94] Watts v. Phillips Jones Corp., 211 App. Div. 523, 206 N.Y. Supp. 735 (2d Dept. 1925), and Burns Manufacturing Co. v. Clinchfield Products Co., 189 App. Div. 569, 178 N.Y. Supp. 483 (1st Dept., 1919), represent the New York law. Dealers' price lists are also admitted, upon proof that there have been actual sales at such prices. Harrison v. Glover, 72 N.Y. 451 (1878).

[95] Peter v. Thickstun, 51 Mich. 589 (1883). *Cf.* Fahey v. Updike Elevator Co., 102 Neb. 249, 166 N.W. 622 (1918); Weigel v. Powers Elevator Co., 49 N.D. 867, 194 N.W. 113 (1923).

[96] Jordan v. Miller, 232 Mich. 8, 204 N.W. 708 (1925); Nelson v. Union Pacific Ry. Co., 116 Kan. 35, 225 Pac. 1065 (1924). Improper use of tabulated reports is considered in Norfolk & Western Ry. v. Fort Dearborn C. & E. Co., 292 Fed. 78 (C.C.A. 4th, 1923), and in Brockman Commission Co. v. Aaron, 145 Mo. App. 307, 130 S.W. 116 (1910).

[97] Courts attempt to guard against misleading testimony by refusing to allow an "expert" to testify where his familiarity is with the wrong market. Kilpatrick v. Whitmer & Sons, Inc., 118 App. Div. 98, 103 N.Y. Supp. 75 (1st Dept., 1907); Foster v. Hudson Wrecking & Lumber Co., *supra* note 55; Georgia Cotton Oil Co. v. Carlisle Seed Co., 200 Ala. 226, 75 So. 984 (1917). But they are curiously reluctant to strike out testimony shown to have been based upon sales in the wrong market.

[98] It was said in Warren v. Mayer Manufacturing Co., 161 Mo. 112, 61 S.W. 644 (1901), that market value can always be shown by evidence of what the plaintiff actually paid to replace, and next best, by the price actually prevailing, or next best, by what people familiar with the commodity thought was its value. The Pennsylvania decisions appear to hold that such prices measure the damages as a matter of law; see Mindlin v. O'Boyle, 283 Pa. 352, 129 Atl. 81 (1925).

[99] Hasler Co. v. Griffing Florida Orchard Co., 133 Ill. App. 635 (1907); Koski v. Haskins, 236 Mass. 346, 128 N.E. 427 (1920); Ditmars v. Sackett, 81 Hun 317, 30 N.Y. Supp. 721 (Sup. Ct., 1894).

One of the most important factors in price determination is the quantity bought or sold. Sometimes the relationship is a uniform one; for example, there is a normal spread of one-eighth or one-fourth of a point between the sale prices of a full lot and of an odd lot on the New York Stock Exchange. But in the ordinary case no such fixed relationship exists, and the price at which a large quantity can be bought or sold can be inferred only roughly from the price of a small one. In *Goldstein v. Arkell & Douglas*,[100] the plaintiff, suing for nondelivery of 1,500 dozen hats, offered in evidence the price which he paid for a dozen similar hats shortly after the breach. The jury was permitted to find that this price measured the market value, per dozen, of the 1,500 dozen contracted for.

In some markets, the buyer of large quantities generally obtains a lower price. But at times he may have difficulty in assembling the large supply, and his efforts to do so may raise the current market prices and therefore the prices which he must pay. There is, therefore, a large risk in assuming, as in *Goldstein v. Arkell & Douglas*, that the price of a small quantity may be applied, without more evidence, to the large quantity involved. The court disposed of this difficulty briefly by saying that, if the defendant wished to show that the price was not representative, he might do so. Presumably, the court would have made the same answer if the plaintiff had contended that the award was inadequate. In other damage cases,[101] and also in other fields of law,[102] we find the courts frequently determining value by these price imputations, which we have discussed in Chap. III, on market value. Such an imputation would work hardship in a case where actual replacement was necessary; but here the courts[103] permit the

[100] 164 N.Y. Supp. 580 (Sup. Ct., 1917).

[101] In Dana v. Fiedler, 12 N.Y. 40 (1854), *aff'g* 1 E. D. Smith 463 (1852), the plaintiff, who owned a large printing establishment, had contracted to buy an unusually large quantity of madder. The seller, when sued for nondelivery, urged that the usual market price of madder was not a fair test, because if delivery had been made to the plaintiff, the latter could not have resold such a large quantity except at a materially lower price. The court rejected this contention on the ground that it was not interested in hypotheses about what would happen in the future to the market price, and it awarded the prevailing price per unit, times the number of units contracted for.

[102] Compare *infra* pp. 716–719 (death taxes); pp. 1035–1040 (income tax); pp. 1141–1142 (rate making).

[103] Haskell v. Hunter, 23 Mich. 305 (1871), awarded spot replacement cost where plaintiff had actually so replaced. And in the leading case of Hinde v. Liddell, L.R. 10 Q.B. 265 (1875), plaintiff replaced shirtings which defendant had failed to deliver, with shirtings of a better grade (the only grade available in the market at the time) and recovered the difference between his outlay and the con-

plaintiff to present evidence of the prices actually paid by him, as bearing on the value of the property in question.

One problem of evidence concerns the admissibility of proof of wholesale price in proof of retail price, and vice versa. The usual absence of any definitely fixed spread between these two prices makes such inferences unreliable. Hence, courts have declined to admit the testimony in the presence of better evidence.[104] But sometimes no more reliable proof can be adduced; and here a court may admit testimony as to wholesale price plus a reasonable markup, or of retail price minus this markup.[105] Moreover, if a retail dealer were to testify that the wholesale value of his destroyed underwear was $1 per garment, we assume that the defendant, on cross-examination, would be permitted to impeach the testimony by showing that the dealer was regularly reselling the garments at only $1.05.

B. The Manufacturer-seller as Plaintiff.[106]

We come now to cases in which the plaintiff is a manufacturer seeking a remedy for the destruction, conversion, or nonacceptance of some

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tract price. The court stated that in such a case the "market value" means the price of the best available substitute. See also Harrison v. Argyle Co., 128 App. Div. 81, 112 N.Y. Supp. 477 (2d Dept., 1908), *aff'd*, 198 N.Y. 628, 92 N.E. 1086 (1910).

[104] Seward v. Pennsylvania Salt Manufacturing Co., 266 Pa. 457, 109 Atl. 617 (1920), rejecting proof of retail price as evidence of wholesale price. See also cases cited *supra* note 97.

[105] As in City of Paris v. Baldwin Bros., 169 Ky. 802, 185 S.W. 144 (1916), where retail prices were established by testimony as to wholesale prices and reasonable markup.

[106] Lack of time prevents us from canvassing adequately the cases in which a manufacturer sues a vendor for the nondelivery of some ingredient of his finished product. These cases are analogous to those considered in the later subsection on The Consumer as Plaintiff. The problem becomes distinctive when the ingredient is irreplaceable and when the manufacturer's output of finished products is therefore curtailed or even completely stopped. Here, the plaintiff's loss resulting from the breach of contract would seem to be measured by his loss of gross sales minus any avoidance of manufacturing and selling expenses. Indeed, in Equitable Gas-Light Co. v. Baltimore Coal Tar & Manufacturing Co., 65 Md. 73, 3 Atl. 108 (1885), where the manufacturer failed to receive a promised delivery of coal tar deemed irreplaceable, and where the court awarded damages measured by the "value" of the tar, this value was deemed equivalent to the resale price of the manufactured fuel less other costs of manufacture. But in Gilman v. Broad Brook Co., 137 Misc. 685, 243 N.Y. Supp. 312 (Sup. Ct., 1930), where a manufacturer of overcoats sued for nondelivery of irreplaceable cloth, the "value" of the cloth was reckoned at that proportion of the sale price of the finished overcoats which the contract price of the cloth bore to the total cost of manufacture

of his products. Here, there can seldom be more than one pertinent "market value," namely, the manufacturer's selling price. If a court should desire to award any significant "replacement cost," it would have to abandon frankly the test of market value and accept instead the test of remanufacturing costs.

But in the very types of conversion cases in which the courts identify the "value" of the *dealer's* merchandise with replacement cost, *manufacturers* have been allowed to recover their selling price. Thus, in *Gunn v. Burghart*,[107] the defendant had converted books (of a quantity not stated in the report) belonging to the plaintiff, a publisher. The latter had sold from five to six hundred copies of the edition to booksellers at a wholesale price of $1.69. This figure was accepted as the measure of recovery, and the defendant's offer to prove the cost of reproducing the converted books was rejected. The court reasoned:

> The true measure of damages in such a case, is at least the market value of the goods at the time of the conversion, with interest thereon, and such market value consists of the price at which the goods can be replaced for money in the market (Wehle v. Haviland, 69 N.Y. 448). This, in the case of manufactured goods, does not mean the cost of manufacture, but the wholesale market rate, as manufactured articles, when there is such a rate. It is only when market value cannot be directly shown, that proof of the cost of production and of other facts and circumstances from which the actual value may be deduced, is of any materiality, and then the value thus established is deemed to be the market value.

The striking thing about this opinion, apart from the result reached, is the purely mechanical application of the rule of another case, based on different facts and reasons. In *Wehle v. Haviland*, which we have already considered, the whole of the dressmaker's stock of goods was seized, and the court limited the award to wholesale replacement prices. It did so in order to exclude selling prices, prompted by the uncertainty that the plaintiff would ever have received such prices for the whole of the merchandise and knowing that she could not have done so without incurring further expense. But in *Gunn v. Burghart*, the court

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—an utterly arbitrary allocation. In Western Industries Co. v. Mason Malt Whiskey Co., 56 Cal. App. 355, 205 Pac. 466 (1922), involving the nondelivery of molasses waste used in the production of potash, the court seems to have left the meaning and measure of the "value" of the raw material completely undefined. It merely admitted the selling price and the cost of production of the potash as "evidence" of value of the waste, leaving the award to the jury's discretion.

See also Michigan Lubrication Co. v. Ontario Cartridge Co., mentioned *supra* note 43.

[107] 47 Super 370, 15 Jones & S. 370 (N.Y. 1881).

sees only that wholesale prices were awarded in the prior case and awards them here, without regard to the fact that they are the plaintiff's *selling* prices or to the possibility of selling all the books at such prices without further expense. The indiscriminateness of the process leads the court into the further fallacy of assuming that such prices represent the cost of replacement, in the only significant sense of replacement cost to the plaintiff. If the plaintiff did go out upon the market to replace—an overwhelmingly improbable event—he would probably have to offer a premium above his customary selling prices for the volumes he was buying back—perhaps the full retail price. The court cannot have intended the extraordinary hypothesis that the plaintiff would buy from himself.

Analysis of this case reveals several prices at which the books *might* have been valued, each appropriate to one possible situation. If the plaintiff's entire stock of goods had been taken, and if he could have sold this entire stock at prevailing wholesale prices, then his loss is measured by such prices minus selling expenses, or by the cost of timely replacement, whichever is less. Replacement would be out of the question unless it was worth his while to print a second edition or to increase the size of an edition already contemplated. If the destroyed books were not all of the publisher's stock, the question is pushed a step back, to whether he could have sold the whole edition, and to whether he would have found it worth while to print another edition. If the plaintiff could not have sold more than the remaining stock of books, he has suffered almost no loss unless the sale of the converted books has impaired his market. If a new edition was intended in any event, and if no sales were lost, plaintiff is out of pocket only the additional cost of increasing the edition. It is apparent, therefore, that only in the exceptional case will the plaintiff's loss be equal to the selling prices of the destroyed volumes.

One may surmise, however, from the result in *Gunn v. Burghart*, that the courts will not interest themselves in such speculations, although they may change the basis of their awards if it appears that in fact a new edition was printed with no intermediate loss in sales. There is much to be said in favor of the court's result. Its simplicity as an administrative rule is obvious. The number of copies of the particular edition that can be sold may be highly problematical, the likelihood of printing further editions even more so.

The same rule is applicable to other producers, as well as to other manufacturers.[108] The farmer, in particular, has been given the benefit

[108] Lathers v. Wyman, 76 Wisc. 616, 45 N.W. 669 (1890); Baltimore & O.C.T. Ry. Co. v. Becker Milling Machine Co., 272 Fed. 933 (C.C.A. 7th, 1921).

of a doubt by the courts,[109] although on the facts presented the likelihood of his selling at the awarded price was small.

The cases thus far discussed concerned tortious interference with a producer's goods. How is it when a manufacturer brings an action for breach of contract to accept and pay for his goods? Three situations should be distinguished: those arising (*a*) when the buyer has countermanded his order before the goods have been made up; (*b*) when he has rejected *resalable* goods after their manufacture; (*c*) when he has rejected *unresalable* goods after their manufacture.

In the first instance, the usual rule precludes the manufacturer from making up the goods, but awards him the difference between contract price and estimated production cost.[110] This rule, which is based on the plaintiff's duty to mitigate damages, might not be applied if stoppage would result in complete shutdown of the factory or if manufacture had already been begun and completion was warranted as a means of minimizing loss.[111]

In the second instance, if title is deemed to have passed, the plaintiff may sue for the contract price, as in the comparable dealer-vendor cases.[112] Otherwise, the plaintiff may recover damages measured by any excess in market value over contract price at the time of the breach.[113] Ordinarily, the "market value" is taken to be equal to the plaintiff's actual resale price.[114] But if the plaintiff retains the merchandise for a considerable period of time, retention will be deemed to constitute an independent risk, and the eventual sale price may be held "immaterial."[115] This measure of damages is subject to the same criticism that may be made against the use of a similar measure in actions by dealer-vendors against defaulting purchasers.

[109] Chi., Gt. W. Ry. Co. v. Gitchell, 95 Ill. App. 1 (1900). Farmer's straw intended for his cattle was destroyed by fire. Court awarded price in nearest market plus cost of transportation. While the theory of the award was correct, the amount was probably excessive. See Bump v. Cooper, 20 Ore. 527, 26 Pac. 848 (1891).

[110] Sedgwick, *Damages*, Vol. II, p. 1568. See Todd v. Gamble, 148 N.Y. 382, 42 N.E. 982 (1892).

[111] These are the only exceptions to the rule expressly mentioned in the textbooks. Yet the rule itself, while ostensibly a device for mitigating damages, might operate to give the plaintiff a *higher* award than he could secure if he were to go ahead with manufacture and were permitted to recover damages based merely on the difference between contract price and selling price.

[112] Uniform Sales Act §63, which also allows recovery of the price if it was due on a specific date irrespective of the passage of title of delivery.

[113] Uniform Sales Act §64.

[114] Sedgwick, *Damages*, Vol. II, p. 1568, and cases cited.

[115] Waumbeck Manufacturing Co. v. Alfrandi, 196 App. Div. 64, 187 N.Y. Supp. 439 (1st Dept., 1921).

Finally, when the goods have already been made up but are not readily salable, the vendor's best and simplest ordinary remedy is to treat the goods as the buyer's and to sue for the contract price.[116] Difficult valuation problems are thus avoided. However, we have found two cases in which the seller sued for damages, either because he had no option to treat the goods as the buyer's or did not choose to exercise it. In *Cody v. American Educational Co.*,[117] the plaintiff had printed, pursuant to the defendant's order, books containing a special flyleaf that made them virtually unsalable; and in *Kelso v. Marshall*,[118] the plaintiff had made special cigarettes for the defendant, which there was no certainty of marketing elsewhere. In each instance the manufacturer-plaintiff was awarded the contract price minus cost of manufacture.

In cases like the two just mentioned, it cannot be assumed that the rejected goods were worth to the manufacturer no more and no less than their production cost. In the book case, the goods were worth to him almost zero—not quite zero since there would always be a possibility of disposing of them at some price, however nominal. Therefore, on the indemnity principle, he should have recovered almost the entire contract price by way of damages. In the cigarette case, the defendant offered to show that the plaintiff could have disposed of a large part of the rejected goods at prices approximating the contract price, by peddling them to clubs and hotels. But the court remained unconvinced, because the evidence failed to show that the cigarettes had a market value. Here, the plaintiff's recovery may have been greater than his loss.

Numerous rationalizations might be offered for the rule of these cases, but dogmatism is unwarranted because the decisions are few and the courts' discussions are perfunctory. In the cigarette case, the sole justification offered for the rule was the decision in *Todd v. Gamble*,[119] where the plaintiff had not yet manufactured. It may well be that the court saw no difference between the two cases; or that if it did, it felt that the same rule should be applied for the sake of simplicity. Apparently the plaintiff was urging the adoption of this rule and was willing to ignore the fact that he had already manufactured part of the goods. If the manufactured cigarettes were not worth to him the cost of manufacture, he might have sued for the contract price. The defend-

[116] Uniform Sales Act §63(3). Many jurisdictions applied this rule prior to the passage of this act. Williston, *Sales*, Vol. II, p. 1398.

[117] 131 Ill. App. 240 (1907).

[118] 24 App. Div. 128, 48 N.Y. Supp. 728 (1st Dept., 1897).

[119] 148 N.Y. 382, 42 N.E. 982 (1892).

ant could not complain, because he failed to show to the court's satisfaction that the goods already manufactured could have been disposed of for more than the cost of manufacture. The important question must be left open—whether the subtraction of the cost of manufacture would prevail in the face of actual proof that the plaintiff was unable to sell the goods for even that amount. It can hardly be doubted that the defendant would be permitted to prove that the plaintiff could have sold the goods for more. But in the cigarette case, the court identified the question as to what the plaintiff could have obtained for the goods with the totally different question as to whether the goods had an established market value. This identity, which of course does not exist in fact, can only be justified on the administrative ground that the only admissible evidence of the manufacturer's ability to sell his goods for more than the cost of manufacture, is evidence of a well-established market and of the prevailing price in that market.

In none of the plaintiff-manufacturer cases have we found discussion of any problems of evidence that have not already been considered in connection with the dealer-seller cases. From the applicable rules for measuring damages, it would appear that the only new problem is the ascertainment of the cost of manufacture. Intricate as this problem often is, it appears not to have survived the rulings of the trial courts. At least, it has evoked no comments from the appellate courts whose opinions we have examined.

C. The Consumer as Plaintiff.

The choice between replacement cost and selling price where a *consumer* is plaintiff presents very different problems from those arising in the *dealer* or *manufacturer* cases. The consumer holds property for use, not for sale; his injury can therefore rarely be measured by his lost opportunity to command a selling price. Moreover, when users sell their property, they generally do so either under pressure to liquidate or because the property has ceased to be useful to them. It is therefore unfair to award to a consumer who is not under pressure to sell and who finds his property useful, the low liquidation figure. Where the property is unused and can readily be replaced, there is no distinction between the user-buyer (our user-plaintiff is almost always a buyer) and a dealer-buyer; in both instances, the replacement cost is the ordinary measure of damages. And the rule is the same whether the action is in contract or in tort.[120]

[120] The use of replacement cost does not depend upon the question whether the article is actively traded in; if it is not, the replacement cost can be determined in other ways. Strangely enough, the courts generally decide the cases in terms

Situations occasionally arise where the article destroyed or contracted for is clearly not worth to the user the amount which it would cost him to replace. Hiram has a farm, located at a considerable distance from other farms and local markets, on which he has hay intended to feed his animals during the winter. The hay is destroyed by a spark from the railroad train. On these facts, a court[121] awarded the replacement cost, that is, the market value at near-by markets plus transportation. But the court intimated that, if the destroyed hay had been in excess of the plaintiff's requirements, his recovery would have been limited to market value *minus* transportation charges. As to the surplus, the court might have treated the plaintiff as a dealer.

Occasionally the question, Which market?, is not answered even by assuming that the plaintiff is entitled to replacement cost. There may be a difference between spot replacement and ordinary replacement, in which case the plaintiff may be granted the spot price if he actually replaced at this price.[122] This type of case arises where the plaintiff, though ordinarily able to buy at wholesale prices because he is a large user, finds it necessary to replace immediately at retail the quantity destroyed or not delivered.

Where the consumer is unable to replace, except perhaps after a serious delay, the court is presented with more difficult alternatives than in the case of the dealer. With dealers, the loss through inability to replace is usually the loss of a profit, and this loss can often be

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of "market value," often described as if *selling* price were the standard. The cases we have found involve such diverse property as a trained bloodhound (St. Louis, I.M. & S. Ry. Co. v. Philpot, 72 Ark. 23, 77 S.W. 901 (1903)); a hunting dog (Greenwald v. Yazoo & M.V. Ry. Co., 115 Miss. 598, 76 So. 557 (1917)); a troupe of trained lions (Knox v. Binkoski, 99 Conn. 582, 122 Atl. 400 (1923)); an engine thresher and gleaner (Hawyer v. Bell, 141 N.Y. 140, 36 N.E. 6 (1894)); a dredge (California Development Co. v. Yuma Valley U.L. & W. Co., 9 Ariz. 366, 84 Pac. 88 (1906)); stereotype plates (Stickney v. Allen, 76 Mass. 352 (1858)); electrotype plates (Heald v. McGowan, 15 Daly 233 (N.Y., 1889)).

A kind of hypothetical original or replacement cost, sometimes combined with "actual value," is used in a number of cases. In Taft v. Smith, Gray & Co., 76 Misc. 283, 134 N.Y. Supp. 1011 (1912), a salesman's "See You" book containing lists of customers and prospects was converted; plaintiff was permitted to show profits made by defendant through its use, and also the manner in which it had been compiled, on the theory that this tended to show the original cost. In Southern Express Co. v. Owens, 146 Ala. 412, 41 So. 752 (1906), the owner of an unpublished manuscript was permitted to testify to its value on the basis of the number of hours employed in writing it and his estimate of the value of his time per hour.

[121] Chi., Gt. W. Ry. Co. v. Gitchell, 95 Ill. App. 1 (1900).

[122] Haskell v. Hunter, 23 Mich. 305 (1871).

roughly allowed for through an award of the dealer's resale price rather than of his replacement cost. But an award to the *consumer* of more than replacement prices cannot be made in terms of an alternative market.

The problem of awarding more than replacement prices in the case of the consumer is sometimes solved by a special allowance for the "value of the use" of the property. In *Williams v. Wood*,[123] the jury had been presented with evidence that *A*, who was claiming damages for the withholding of a threshing machine, was prevented from performing his contracts for threshing because of the temporary absence of the machine, even though it was eventually returned to him. There was a verdict for $375. The court held the admission of this evidence error, since the damages "were clearly anticipated profits and too conjectural and uncertain to furnish a proper basis for estimating compensation to the defendant." On a new trial, the judge instructed the jury to award, not the anticipated profits that could have been made from the use of the machine, but merely the "value of the use" during the period in question. The jury reached a verdict for $500, and this was affirmed on a second appeal. In other words, the jury was almost certainly swayed by the same considerations as to lost profits that had moved the first jury. Everything, however, was orthodox, since the court and counsel had talked of the "value of the use." By refusing to permit the award of lost profits, while allowing the award of high rental or use values, courts do not produce a very profound change. But, if "use value" is restricted to *ordinary* rental value, a workman's recovery for the loss of his tools would be very small—much smaller than the loss actually suffered if he was forced to remain idle until he could replace his tools. In such a case, a few courts have allowed full recovery by stating that the measure of damages is here the (special, temporary) value of the tools to the owner himself.[124]

Unless the courts are willing to go farther than they have yet gone in expanding the concept of "value of the use," or in permitting a valuation of property at its special value to the owner, the user's recovery of damages in excess of ordinary replacement cost must depend on his ability to secure "special damages" measured directly by his estimated loss. This point is illustrated by a Massachusetts

[123] 55 Minn. 323, 56 N.W. 1066 (1893); (same) 61 Minn. 194, 63 N.W. 492 (1895).

[124] The cases on this subject are complicated by procedural questions, the allowance frequently depending on the nature of the action. Compare Sedgwick. *Damages*, Vol. II, pp. 985–990 with pp. 1029–1052.

case involving nondelivery of building plans.[125] The lower court decided the case in terms of the "value" of the plans, meaning thereby what they would have been worth to the plaintiff as a means of saving him from the loss that he actually suffered because of their non-arrival. In reversing the judgment, the upper court took the position that, in a case of this nature, the problem is not to find "value," but to determine whether the damage caused by the delay was a contemplated risk and had been established with sufficient approach to certainty.

[125] Mather v. American Express Co., 138 Mass. 55 (1884).

CHAPTER XIV

VALUATION UNDER THE LAW OF DAMAGES, CONTINUED

IV. Value as Dependent on the Type of Property.

In the previous chapter we have emphasized the different interpretations of the phrase "value of the property" that are due primarily to differences between classes of individuals who sue to recover damages. For the most part, these distinctions are more important than those due to the particular nature of the property. But there are certain types of property to which special rules of valuation have been applied, and the more important of these types must now be considered.

A. Securities and Commodities with a Fluctuating Market.

As applied to most commodities, "market value" is ambiguous because of the diversity of markets and the limitation of persons who have access to any one market. Mobilization of goods and money may, however, reach the point where the market price is fairly uniform for small and large quantities, and where all comers have access to the same market.

This is notably true of securities listed, and actively traded in, on the stock exchanges. Given the moment of time as of which a market value must be found, the determination of this value is usually subject to little dispute except within a trivial range of prices and except for unusually large blocks of securities.[1] But it is not easy to find the precise moment of time at which the breach occurred, or to justify the application of the price at that moment as the fairest measure of recovery.

Take the typical case of the conversion by a broker of securities belonging to a customer. If the conversion is considered to have taken

[1] Except in the case of large lots, we have found no damage case involving this problem. The closest case is Hershey v. Hanauer, 108 Wash. 498, 185 Pac. 627 (1919). The plaintiff gave the defendant broker 15,000 shares of stock to sell on the exchange, of which 1,000 shares were forthwith sold at 15¼ cents per share. The next day the plaintiff demanded back 11,000 of his shares, since he had sold them to a third person for 11 cents per share. Return was refused, and the stock subsequently became much less valuable. The trial court directed judgment for defendant on the ground that there was no evidence of market value on the day of demand. But the appellate court reversed, holding that the sale by plaintiff for 11 cents was *some* evidence.

The problem frequently arises in inheritance taxation. See Chap. XXI.

place at the moment of unlawful sale by the broker, the customer will frequently be remediless if he recovers only the market value at that time, because the price realized at that moment will ordinarily be the then market price. The customer will probably be ignorant of the fact of sale until he receives a notice of it on the succeeding day, after a change in prices has already taken place.

Recognizing this situation, the courts have uniformly applied rules for the recovery of damages for the loss of securities and other commodities of rapidly fluctuating prices, which differ in result, at least,[2] from the rules applicable to ordinary commodities. The precise nature of these rules, and the types of commodities that come under them, vary as among jurisdictions. They had their origin in stockbrokerage cases, and possibly their existence is to be ascribed to some extent to the dislike of courts for the profession of stockbrokering, associated in the earlier literature with the condemning epithet of "stockjobbing." The necessity for some leeway in the time and manner of replacement exists to some extent in every case; the "fluctuating-commodity" cases differ only in degree. It may be that this difference in degree is sufficiently striking in and of itself to account for some variation in the applicable rules. It may be that the lack of a similarly precise market price in the case of other commodities enables the plaintiff to prove a "market value" which in fact takes into account the state of the market for the period succeeding the date of the breach, as well as that immediately preceding it.

Because of the commercial importance of stocks and other fluctuating commodities, this subject has received widespread attention in the standard textbooks[3] and need not be discussed in detail. Stocks, wheat, corn, cotton, and other commodities for which there are organized exchanges, are thus recognized. It is unsafe to predict beyond that, as to such things as lumber, onions, donkeys, etc., without consulting the precedents of the particular jurisdiction.

The rule finally evolved in New York,[4] and adopted in most other jurisdictions and by the United States Supreme Court,[5] is that the plaintiff may recover the highest market value at any time during a

[2] The reason for stating that the difference is at least in *result* is the argument in Sedgwick, *Damages*, Vol. I (9th ed., rev., New York, 1912), pp. 453-462, that the cases are illustrative of ordinary principles of the law of damages.

[3] Sedgwick, *Damages*, Vol. II, Chap. 22; Charles H. Meyer, *The Law of Stockbrokers* (New York, 1931).

[4] Baker v. Drake, 53 N.Y. 211 (1873); Wright v. Bank of Metropolis, 110 N.Y. 237, 18 N.E. 79 (1888).

[5] Galigher v. Jones, 129 U.S. 193 (1888).

reasonable interval after his knowledge of the wrong. Some jurisdictions[6] permit the plaintiff to choose any value up to the time of trial, with or without limitation as to the time the plaintiff can wait before bringing his action. In actions for breach of sales contracts, some courts restrict the rule of "highest intermediate value" to cases where plaintiff has paid the purchase price in advance.[7] Florida[8] permits the plaintiff to recover the market value at any time that he selects up to the day of trial, but only if he convinces the jury that he would have held the securities until that time![9]

The converse of the highest market price rule is applied to other wrongs involving securities. For example, if a broker wrongfully covers a short position, the customer is given the benefit of a presumed sale at the *lowest* price within a reasonable time.[10]

B. Misrepresented Securities or Commodities.

The "fraudulent-misrepresentation" cases may be considered here, since most of them involve securities subject to the "fluctuating-market" rule. They are of special interest for their distinctions between "value" and prevailing market price.

We must note first a diversity of authority as to the correct measure of damages in fraud cases. The rule in the majority of jurisdictions[11] is that a defrauded buyer may recover any excess in the value of what he would have received if the property had been as represented, over the value of what he in fact received. The minority rule[12] awards to the purchaser the excess in the purchase price (or the value of what he parted with) over the value of what he received.

[6] See cases discussed in Sedgwick, *Damages*, Vol. II, Chap. 22.

[7] See McCormick, *Handbook on the Law of Damages*, p. 187. Some courts have held that, in such a case, the purchaser of an ordinary commodity is entitled to the highest value to the time of trial. Early decisions of this character were cited in Romaine v. Van Allen, 26 N.Y. 309 (1863), which apparently started the special rule in stock-brokerage actions in this country.

[8] Moody v. Caulk, 14 Fla. 50 (1872).

[9] In McIntyre v. Whitney, 139 App. Div. 557, 124 N.Y. Supp. 234 (1910), *aff'd*, 201 N.Y. 526, 94 N.E. 1096 (1911), the brokers converted plaintiff's stock. After the conversion and without knowledge of it, plaintiff advanced additional margin. The price for a reasonable time after discovery of the wrong was less than the price realized upon the conversion. The court awarded the latter.

[10] Meyer, *Law of Stockbrokers* (New York, 1931), p. 569.

[11] Sedgwick, *Damages*, Vol. II, pp. 1622–1624. Note, however, that New York appears to have shifted to the other rule. Reno v. Bull, 226 N.Y. 546, 124 N.E. 144 (1919).

[12] Sedgwick, *Damages*, Vol. II, pp. 1624–1631. The minority rule approaches a rescission; that is, it is aimed to restore to the injured party the value of what he parted with.

Before considering the application of these rules to cases involving securities, we may take note of one case involving ordinary merchandise. *Durst v. Burton*[13] arose in a state adhering to the majority rule. The plaintiff had purchased cheese for delivery in New York, paying $6,800. Concealed defects made the cheese worth only $5,400 in the New York market. At the trial the defendant offered to show that the plaintiff had resold the cheese in London for $6,600. The testimony was barred and a resulting verdict of $1,400 was affirmed on appeal.

Two things will be noted in this case. In the first place, the price that the plaintiff paid for the cheese is assumed, without discussion, to measure what it would have been worth if the representation had been true.[14] Presumably a plaintiff would be entitled to prove an even higher value; but he can rely upon the *assumption* that the goods as represented would have been worth what he paid. In the second place, the "actual value" of the defective cheese in the New York market is taken irrespective of the fact that the plaintiff in fact realized a greater sum elsewhere. We cannot be sure whether "actual value" means the amount which the buyer would have to pay to get other cheese of the defective quality, or the amount for which he could have sold such cheese. This suggests the further question whether the "value" of nondefective cheese should be taken to mean replacement cost, as was apparently done, or selling price. It would seem that the former meaning should be accepted in the absence of special circumstances, such as loss through inability to replace.

Where there has been misrepresentation as to the *quantum* of land conveyed, the measure of damages is said to be the difference between the value of the tract as represented and the value of the tract actually conveyed.[15] The cases reveal but little controversy on this point, although the analogous rule in the "partial-taking" cases under the law of eminent domain has raised many difficulties.[16]

While interesting problems are thus raised in the fraud cases involving goods and realty, the vital questions are best illustrated by cases dealing with the fraudulent sale of securities. Here, too, there is the same division of authority as to the measure of damages. Our interest, however, is in the question what the court means by the

[13] 47 N.Y. 167 (1872).

[14] Compare Lovejoy v. Isbell, 73 Conn. 368, 47 Atl. 682 (1900).

[15] Lovejoy v. Isbell, *supra* note 14; see Salyer v. Blessing, 151 Ky. 459, 152 S.W. 475 (1913); Sedgwick, *Damages*, Vol. III, pp. 2145–2147.

[16] *Infra* pp. 421–422.

"value" either of what the plaintiff actually received or of what he *should* have received.

First let us compare two famous English cases. *Twycross v. Grant*[17] was an action by a subscriber to stock in a corporation formed to operate streetcars in a Portuguese city. He had been deceived by a prospectus issued by the defendants, which had failed to state that the streetcar line was being constructed at an exorbitant profit, part of which inured to the benefit of the defendant directors. After 16 months of operation the company went into the hands of a receiver. The plaintiff contended that the measure of damages was the entire £700 which he had paid for the shares; and this sum was awarded by the jury. The defendants on appeal urged that for a considerable time after the purchase the shares had been selling at about the price paid for them by the plaintiff, and that even much later they had sold for a substantial fraction of that sum. This is the contention uniformly made and rejected in stock-fraud cases. Obviously, the formula "the difference between the amount paid and what the shares were worth" cannot be interpreted in accordance with this contention that market prices determine what the shares were "worth." To do so would deprive the plaintiff of all damages whenever the fraud was so effective as to bolster up the market for a long time.

The Common Pleas Division, instead of saying frankly that this was one of the cases in which *market value*, though it exists, must be rejected as a legal standard, talked loosely about market price as mere "evidence of value," which a jury could reject if it saw fit. Yet, if a jury were to reject market price in an ordinary action by buyer or seller, its verdict would be set aside. Practically all the judges, in the Common Pleas and in the Court of Appeal, declared that the correct rule of damages was that the plaintiff might recover all that he had lost as a direct and natural consequence of the fraud.

Peek v. Derry[18] was likewise an action against directors for issuing a false statement. The plaintiff had paid £4,000 for shares in a corporation organized to operate a streetcar line between two English cities, on the faith of the defendants' representation that the company would be authorized to operate the cars by steam power. As a matter of fact, such authorization was withheld by some of the cities interested, as a result of which operation became economically impossible and the

[17] 2 C.P.D. 469 (1877); (same in Court of Appeal) 2 C.P.D. 491 (1877).

[18] 37 Ch. D. 541 (1887). The case was ultimately reversed by the House of Lords on the ground that the misrepresentations were not actionable because made negligently and not fraudulently. Derry v. Peek, 14 App. Cas. 337 (1889). The rule was changed by legislation in 1908; see Companies Act, 1929, Sec. 37.

company lost its investment. Cotton, L.J., delivering the opinion of the Court of Appeal, held that the measure of damages was the difference between the subscription price and the "value" of the stock at the time it was delivered. This did not mean that the court was accepting the defendants' contention that the "value" was measured by the price at which the shares were selling in the market; far from it. The court explained that, while the value of the shares should be determined as of the time of purchase, the subsequent events might be considered as "evidence" that the shares were originally "worthless." On the other hand, a subsequent depreciation in the worth of the shares occasioned by events having no connection with the misrepresentation could not be considered as affecting the actual value.

It is not clear how far the two English decisions meant to lay down different rules. The latter opinion cited the former one, and they are apparently both considered good law in England. Nevertheless, a reading of the language of the two sets of judges shows a difference of approach which, in some circumstances, would lead to a difference in result, and which furthermore has a distinct bearing on valuation theory.

If the language of *Twycross v. Grant* is taken literally, we are little concerned with the "value" of the shares at the time of the fraud. All that is important is that the fraud induced the plaintiff to invest and that he lost his investment. We may assume, although it was not so indicated, that the court would not apply the rule to a case in which the loss was *not* due to the facts misrepresented or concealed. The important point is that the inquiry went directly to the question of the plaintiff's loss by reason of the wrong, with a merely incidental reference to value concepts.

Peek v. Derry, on the other hand, lays primary emphasis on the "*value*" of the shares. Its ambiguity as to the evidentiary force of the subsequent events leaves two possibilities open: The court *may* have meant that, whenever the subsequent course of events shows that the fraudulently concealed facts brought the company to ruin, then the "value" of the stock at the time of the fraud shall be considered to have been zero. If this is so, it might be admitted that, although the court *talks* valuation, it is really interested only in the amount of the ultimate loss. But an alternative interpretation is possible. The court *may* have meant that the shares should be valued at what a person would have paid for them at the time of the wrong, *had he then known the true situation.* For example, on the facts of *Peek v. Derry*, a purchaser knowing that the use of steam power was subject to approval by the various cities, might nevertheless believe that there was a very high

probability[19] that such approval could be secured; and while he might not have paid all that the plaintiff paid for the shares, he might nevertheless have paid a substantial sum. In other words, *Peek v. Derry* is capable of an interpretation which would make it genuinely interested in valuation and which would give the defendant the benefit of the value of the chance that disaster could have been averted, measured as of the time of the fraudulently induced purchase.

An important recent American case is *Hotaling v. Leach.*[20] The plaintiff had bought a bond for $980 on the faith of defendant's statement that it was excellently secured, whereas in fact there was but a small margin of security. Two years after the purchase, the corporation encountered a severe depression in the industry and was forced to reorganize, although the depression could perhaps have been weathered if the corporation had been as comfortably fortified with assets as the defendant had represented. All that the plaintiff got for his bond, which he had deposited with the reorganization committee, was a cash payment of $5.84 (the proceeds of the sale of the corporate assets to the protective committee), or a right to participate in the reorganization, which he could not sell and which required the risking of an additional $150. The plaintiff was allowed to recover $974.16. Said the Court of Appeals in affirming the judgment:

> "The true measure of damage is indemnity for the actual pecuniary loss sustained as the direct result of the wrong." (Reno v. Bull, 226 N.Y. 546). . . . As long as the fraud continued to operate and to induce the continued holding of the bond, all loss flowing naturally from that fraud may be regarded as its proximate result. Change of conditions may have been a subsidiary cause; it was not an independent cause. The loss sustained is directly traceable to the original misrepresentation of the character of the investment the plaintiff was induced to make.

Nevertheless the court also used language highly reminiscent of *Peek v. Derry,* which it cited and quoted:

> At least the plaintiff's proximate damages should be the difference between the price paid upon the purchase and the value of the bond at that time as an investment, the purpose for which it was understood that the plaintiff was buying. Ultimate loss of the investment was due to weakness inherent in the investment concealed by the defendant. That weakness might not under all circumstances have produced the ruin of the company. It did produce that ruin when conditions demanding greater financial strength arose in the oil

[19] As shown by the fact that such consent was obtained from all but one of the cities.

[20] 247 N.Y. 84, 159 N.E. 870 (1928).

trade. The loss proximately caused by the defendant's fraud is the difference between the price he paid and the value of what he received when put to the use contemplated by the parties. In this case that value must be determined in the light of subsequent events.

Looking at the problem in the light of future prospects, the value of the bond as an investment at the time of its purchase was probably far more than $5.84. As Judge Lehman admits, the financial weakness of the company might not under all circumstances have produced ruin; in other words, there was a respectable chance that the company would muddle through, and even if all the facts had been known, an intelligent buyer might have paid a substantial amount for the bond. Only if "value" as of a certain time is to be determined, not in the light of the *probability* of subsequent events, but as if those subsequent events had already happened, was value here being inquired into at all.[21] On the whole, it would seem that *Hotaling v. Leach* is one of the cases which ask only, How much has the plaintiff lost as a direct consequence of the wrong?

Smith v. Duffy[22] indicates, at least verbally, still another approach. In rejecting the inevitable argument of the defendant that the "actual value" of the shares should be taken to be the market price at the time of the fraudulent sale, inflated though it was by the widespread misstatements, the court said that the stock should be valued at what it would bring after the fraud ceased to be "operative." This is all very well if no factors have affected the value of the stock between the time of purchase and the time of discovery of the fraud, except the very facts which were misstated. But suppose that there has been a wholly independent intervening event. Imagine for instance that the company's property is destroyed by an earthquake. As was said by the New York court in criticizing this rule, "such a rule, if unvaryingly applied, might allow a defaulting purchaser to include in his damage a loss which was the result of an intervening cause distinct from the fraud. It has not been generally accepted."[23]

[21] Hotaling v. Leach contains other interesting points; *e.g.*, its holding that the upset price realized in a receivership sale does not establish the value of the property bought; and its discussion of the right to participate in the reorganization as being a new and special risk which the plaintiff need not assume, and from which the defendant could neither gain nor lose.

[22] 57 N.J.L. 679, 32 Atl. 371 (1895).

[23] See 247 N.Y. 84, 92, 159 N.E. 870, 873. Two other American cases should be noted in this connection: Whiting v. Price, 172 Mass. 240, 51 N.E. 1084 (1898), an illuminating commentary upon Peek v. Derry; and Hindman v. First National Bank, 112 Fed. 931 (C.C.A. 6th, 1902).

When a court concentrates attention upon the difference between the purchase price and the "actual value" of the stock at the time of purchase, further difficulties naturally arise. How is the "actual value" to be determined? Shall one guess at what the market would have paid if the facts had been generally known? Or, to avoid such speculation, should the court look to book value? *Taylor v. Thomas*[24] is an interesting case. The defendant directors of a bank had issued a statement showing a capital of $100,000, a surplus of $50,000, and undivided profits of $13,456. They concealed the fact that $194,107 of the bank's assets were of doubtful value. Thereafter, all but $97,000 of these assets were in fact realized upon. The bank, however, was in such a weak condition that its entire capital was ultimately wiped out. In the trial court, the plaintiff, who had bought on the faith of the statement, was allowed recovery of the full purchase price of his shares. The appellate court, however, held that the question was, How much less valuable were the shares, at the time he bought them, than as represented?—a question to be answered by a comparison of reported and corrected book values. The court subtracted the $97,000 of uncollected assets from the bank's resources, which wiped out the surplus and left a capital of $66,456. This $66,456 of capital it prorated among the shares of stock and required the plaintiff to give the defendants credit for a proportionate share, *i.e.*, the corrected book value of the stock which he bought.[25]

On the other hand, in the case[26] of an insurance company, where there was misrepresentation as to the amount of loss, it was held error to charge the jury as a matter of law that the proportionate difference in book value between the represented and the actual state of affairs constitutes the measure of damages, since the market value of shares was not solely dependent upon the book value. Presumably the court meant by this that the proper procedure was to estimate the effect that a statement of the true condition of the company would have had upon the market value of the shares.

Although the award of the entire purchase price may seem excessive in that it relieves the plaintiff from the effect of adverse business conditions which would have affected his investment even if it were as represented, the deduction of the estimated value of the security might be grossly unfair to the plaintiff. The security may have been represented to be a gilt-edged investment, suitable for the plaintiff

[24] 124 App. Div. 53, 108 N.Y. Supp. 454 (1908), *aff'd*, 195 N.Y. 590, 89 N.E. 1113 (1909).

[25] See also Mills v. Knudson, 54 Wash. 614, 103 Pac. 1123 (1909).

[26] Hubbell v. Meigs, 50 N.Y. 480 (1872).

because he was a person of limited means. An award of the purchase price less the estimated value makes the plaintiff run a risk which he never contemplated running, and makes him pay a price for an opportunity which was never worth that price *to him.*[27]

C. Land.

In the "fluctuating market" cases discussed in Subsection *A*, the most important question at issue has usually concerned the *time* of valuation. Once this question has been settled, other problems, such as the choice between a wholesale and a retail market, or such as the establishment of a current market price, have not often given serious difficulty. We turn now to types of property which, like the active securities, have not often required a choice between different markets, but which, unlike these securities, have raised perplexing problems in appraisal because of their unstandardized nature and because of the relative infrequency of sales. Real property belongs in this category and will be considered first. To be sure, most of the legal precedents as to the valuation of real property are to be found in the laws of eminent domain, taxation, and fire-insurance appraisals. But the sporadic cases under the law of damages are worth noting for comparative purposes.[28]

In actions involving land we are met with two factors which distinguish them from the ordinary commodity case, in addition to the factors just considered. In the first place, the problem of a tortious taking of land seldom arises;[29] most of the cases deal with breaches of contract. In the second place, the remedies for breaches of land contracts are different from those afforded for other contracts. It is universally recognized[30] that, in addition to whatever common-law remedy may exist, "the party willing to perform a contract to buy land may compel performance" by an action in equity in which he may obtain a decree requiring the payment of the purchase price or the delivery of a deed, as the case may be. There is also an extraordinary

[27] There are other considerations. The discovery of the fraud would ordinarily lead to a decline in price below the price that would prevail for the investment apart from the misrepresentation, because the resulting lack of confidence in the management would lead to a selling wave.

[28] For the problem of "boom" value see *infra* p. 357.

[29] The exceptional situation is of the type known as permanent nuisance or trespass, discussed *infra* p. 330. Miller v. Belville, 98 Vt. 243, 126 Atl. 590 (1924), was a conversion of a deed, so that plaintiff was deprived of title to his land; market value was awarded. In passing upon the measure of damages, the court held that plaintiff's purchase price 10 years previous was inadmissible.

[30] Edward Fry, *Specific Performance* (6th ed., London, 1921), *passim.*

rule[31] in many jurisdictions that, where the seller is innocently unable to perform—for example, where there is an encumbrance or a flaw in title, of which the seller was unaware—the buyer may not recover for the loss of his "bargain." The buyer has no corresponding excuse; if he does not perform he is liable to the seller for the resulting damage.

In the usual case where recovery is allowed, the measure of damages is the difference between the contract price of the land and its "market value" as of the time when the deed was promised.[32] Most of these cases ignore the question whether the valuation should be in terms of a buying price or of a selling price. This is explained by the absence of distinct wholesale and retail land markets. Save in the case of development projects and booms, land is not regularly bought at one price for quick resale at an enhanced price. Between what a given kind of land can be bought for if the buyer takes a reasonable time, and what it could be sold for if the owner advertises it for a reasonable time, there is no distinction sufficiently clear to concern the courts. In *Boyd v. De Lancey*,[33] where the buyer purchased a plot for subdivision development, the seller was unable to give good title. The buyer sought to recover the profits which he claimed he would have made. The court held that the usual rule applied, and that the value of the plot as a whole must be taken. A contrary holding was hardly to be expected.

Assuming that the buyer had already incurred expenses for advertising literature and plans, he should recover for them, particularly where, as here, the seller knew the purpose for which the land was purchased. However, in *Chamberlin v. Brady*,[34] it was held that a purchaser who, before learning that the seller could not convey, employed an architect to prepare plans for a house, could not recover for this expense.

One rule of evidence, peculiar to real estate, may be noted here. In New York[35] and a few other jurisdictions,[36] testimony as to the sale prices of adjacent land has been held inadmissible, or at least has been severely restricted. The defense of this rule is that every tract

[31] The leading case is Flureau v. Thornhill, 2 W. Bl. 1078 (1776). The English law was finally settled by Bain v. Fothergill, L.R. 7 H.L. 158 (1874). For a discussion of the extent to which this decision is followed in America, see Sedgwick, *Damages*, Vol. III, pp. 2108–2124.

[32] See Sedgwick, *Damages*, Vol. III, pp. 2131–2133, 2139–2142.

[33] 91 Hun 542, 36 N.Y. Supp. 245 (1895); *on later appeal*, 17 App. Div. 567 45 N.Y. Supp. 693 (1897).

[34] 49 Super. 484, 17 Jones & S. 484 (N.Y., 1882), *aff'd*, 94 N.Y. 649 (1884)

[35] Witmark v. N.Y. Elevated Ry. Co., 149 N.Y. 393, 49 N.E. 78 (1896).

[36] See Pittsburgh & Western R.R. v. Patterson, 107 Pa. 461 (1884).

of land is, in some respects, unique, and hence that testimony as to the sale prices of other tracts would raise the difficult problem of determining degrees of similarity. While there is merit in this position, the balance of advantage is in favor of the admission of the testimony;[37] and most courts hold the evidence admissible, leaving the control of the administrative difficulties to the discretion of the trial judge.[38]

The tort cases involving land are of miscellaneous character. The rules governing the wrongful cutting of timber are mentioned elsewhere. Minor interferences with the beneficial use of land, such as wrongful entry, slight injury to the soil, and trespasses by animals, are generally disposed of by awarding the cost of repairing the injury.[39] Where the owner is also deprived of the use of the land for a period of time, the rental value for such period is added to the cost of repair.[40]

One class of cases has raised a peculiar valuation problem, namely, the cases involving permanent nuisance or trespass. The distinction between a "permanent" nuisance and a merely temporary one is not altogether clear. In some cases the defendant is content to have the plaintiff's damages assessed on the theory of a permanent injury. For example, if an action is brought in equity to restrain a backing up of water on plaintiff's land by means of a dam, and if the defendant could have acquired a license to do so under the power of eminent domain, the court will, as a rule, refuse an injunction if the defendant is willing to pay in exchange for a deed the amount that

[37] See our mention of the same problem under the law of eminent domain, *infra* p. 430, note 58; and the discussion in our monograph on *Valuation under the Law of Eminent Domain* (Charlottesville, Va., 1936), by Lewis Orgel, Chap. 12.

[38] Massey v. Fain, 1 Ala. App. 424, 55 So. 936 (1911); see John Wigmore, *Evidence*, Vol. I (2d ed., Boston, 1923), §463 and cases cited. There seems to be a division of authority as to introduction of original cost of the land involved in the litigation. *Pro:* Swanson v. Keokuk & W.R.R., 116 Iowa 304, 89 N.W. 1088 (1902); *contra:* Ringer v. Wilkin, 32 Idaho 330, 183 Pac. 986 (1919). The fact situations may justify the different results.

[39] Sedgwick, *Damages*, Vol. III, pp. 1918–1921, states: "If the injury is easily reparable, the cost of repairing may be recovered. But it must be shown that the repairs were reasonable; and if the cost of repairing the injury is greater than the diminution in market value of the land, the latter is always the true measure of damages. Strictly speaking, therefore, the cost of repairs is not the measure of damages, but only evidence of the amount of damages. . . . Both cost of repairs and permanent depreciation cannot be recovered in the same case." For a holding that the cost of repair is not recoverable where it greatly exceeds the depreciation in value, see Hutchinson v. Parker, 64 N.H. 89, 5 Atl. 659 (1886).

[40] Higgins v. Los Angeles G. & E. Co., 159 Calif. 651, 115 Pac. 313 (1911); Sedgwick, *Damages*, Vol. III, p. 1917 and cases cited.

would probably have been awarded in a condemnation proceeding. In general, where the injury to the plaintiff's land is of a kind regarded as permanent, the measure of damages is the difference between the value of the land before and after the injury.[41] This is a rule often adopted in a condemnation proceeding, and the same principles of valuation are applied.[42]

D. Leaseholds.

Attempts by landlords to prove unliquidated damages for breach of a lease agreement are rare, because in practically all cases the tenant is liable for the rent, or for the same amount as damages, even though the tenant has abandoned the premises or has been dispossessed for breach of the covenants of the lease. Practically the only instance in which damages are sought is where the tenant is an insolvent corporation. In that case the continued liability for rent is of no value, and the landlord seeks to prove unliquidated damages so that he may share in the assets with the other creditors.[43] The cases in which landlords have been permitted to prove such claims are few.[44] In one of them the landlord had, in fact, relet for the balance of the term, and the discounted difference in rental was awarded.[45] Where a landlord had not relet, he was permitted[46] to prove his loss by the same calculation, but with the probable rental as a basis, this being the basis provided for by the lease.

The lessee may be plaintiff for a variety of reasons. Where he is permitted to recover the value of his lease,[47] his proof will consist of

[41] Sedgwick, *Damages*, Vol. III, pp. 1902–1903. The phrasing varies from "value" to "market value" and "fair market value." The last was preferred to "fair cash value," but the court refused to reverse on the ground that the jury was not misled. Pulaski Oil Co. v. Edwards, 92 Okla. 56, 287 Pac. 876 (1923).

[42] See *infra* pp. 421–422.

[43] See W. S. Schwabacker and S. C. Weinstein, "Rent Claims in Bankruptcy," 33 *Col. L. Rev.* 213 (1933).

[44] Recent developments have made landlords' claims provable. See Irving Trust Co. v. A. W. Perry, Inc., 293 U.S. 307 (1934) Note the provability, to a limited amount, of rental claims under Sec. 63 (*a*) of the Bankruptcy Act as amended June, 1934; and under Sec. 77B (*b*) of the Bankruptcy Act. See J. M. Jacobson, "Landlord's Claims Under Sec. 77B of the Bankruptcy Act," 45 *Yale L.J.* 422 (1936).

[45] Filene's Sons Co. v. Weed, 245 U.S. 597 (1918).

[46] Dickerson v. Menschel, 188 App. Div. 547, 177 N.Y. Supp. 376 (1919).

[47] See Herbert Tiffany, *Landlord and Tenant* (1912), Vol. I, pp. 391, 547; Vol. II, p. 1291.

expert testimony that his lease was a great bargain.[48] His experts are prone to measure the value of the lease by totaling the entire difference between the rent specified in the lease and their opinion of the annual "rental value" of the property, making no discount for the time element. But the courts compel the making of proper discounts where long-term leases are involved.[49]

E. Buildings.

Where a building is part of land subject to a contract of sale, it does not ordinarily constitute a separate item of property to be valued. The valuation is of the improved land and proceeds on the same lines as with unimproved land, with two exceptions: (*a*) the majority of cases permit the reproduction cost less depreciation of the building to be shown;[50] (*b*) all courts permit the rental value to be stated.[51]

The possibility of valuing the building separately, only occasionally recognized where the value of the improved land is involved, is definitely accepted in a number of cases dealing with the destruction of buildings. Some courts[52] state that the owner of a destroyed building may recover the difference in the value of the land before and after the destruction, which is stated to be "the depreciation in the market value of the whole property caused by the destruction of the building." It is also said[53] that the cost of restoration is recoverable, with a suitable allowance for age and depreciation. Still other courts[54] hold that a building is capable of a separate valuation and that such sum, rather than the depreciation in the value of the whole or the cost of restoration, should be awarded. However, the latter

[48] Sedgwick, *Damages*, Vol. III, p. 2045 and cases cited; Williamson v. Stevens, 84 App. Div. 518, 82 N.Y. Supp. 1047 (1903); Wertheimer v. Rosenbaum, 146 N.Y. Supp. 177 (1914).

[49] Bondy v. Harvey, 218 App. Div. 126, 217 N.Y. Supp. 877 (1926), stating that this has been frequently overlooked. *Cf.* Hollwedel v. Duffy-Mott Co., Inc., 238 App. Div. 468, 264 N.Y. Supp. 745 (1933), applying same rule to employment contracts.

[50] Compare the eminent-domain cases, *infra* p. 427, and Chap. 16 of Orgel's monograph, cited *supra* note 37.

[51] Ettlinger v. Weil, 184 N.Y. 179, 77 N.E. 31 (1906); Shotwell v. Smith, 3 Edw. Ch. 588 (N.Y. 1842). Compare the eminent-domain cases, Orgel, *op. cit.*, Chap. 15.

[52] Cincinnati, C.C. & S.L. Ry. v. McKelvey, 12 Ohio C.C. 426 (1895); Pacific Express Co. v. Lasker Real Estate Association, 81 Tex. 81, 16 S.W. 792 (1891).

[53] See Marks v. Culmer, 6 Utah 419, 24 Pac. 528 (1890).

[54] This is the majority rule, as shown by cases cited by Sedgwick, *Damages*, Vol. III, p. 1934, n. 127.

courts do not agree as to whether it is the "market value" or the "real" or "actual" value of the building which measures the award. Most of them reject market value, either on the ground that a building has no market value, or that this value would not indemnify the owner. The cases that reject market value consider it to be the price for which the building could be sold apart from the land, while the cases that accept market value define it as the value "in view of the uses to which it has been devoted and to which it is available," that is, in connection with the land on which it is located. To prove this ill-defined value, the courts permit the cost of reconstruction to be shown[55] and admit opinion evidence of value, apparently based on the difference in value of the improved land before and after the destruction of the building.

Courts[56] which purport to value the building on the basis of its "actual value" permit such value to be shown by proof of reproduction cost, extent of depreciation, original cost, location, fall in market value, evidence as to the success or failure of the business conducted in the building, if any. All of this testimony, with the possible exception of proof of original cost, would be equally admissible under the fall-in-market-value test, and most of it under the reconstruction-cost test, which is, however, the least flexible. Difference in market value may, of course, be testified to directly by experts, who may either state their opinion as to such difference or state their opinion of the value before and after the destruction of the building.

Depreciation is the largest problem presented by the building cases. A number of cases,[57] employing either a "market-value" or an "actual-value" test, indicate that obsolescence is to be considered as well as physical depreciation. The formulation of the reconstruction-cost test makes it uncertain to what extent obsolescence would be considered, although no case has been found specifically discussing this question.[58] As to the method of determining the extent of depreciation, no test has been formulated. Experts have been permitted

[55] Wall v. Platt, 169 Mass. 398, 48 N.E. 270 (1897).

[56] Patterson v. Kingsland, 8 Blatchf. 278 (C.C.E.D. N.Y., 1871); Jacksonville etc. Ry. Co. v. Peninsular Land Co., 27 Fla. 1, 9 So. 661 (1891). Connor v. Mo. Pac. Ry., 181 Mo. 397, 81 S.W. 145 (1904), allowed this evidence where market value was said to be the test. Proof of condition is necessary to support a verdict: American Coal Co. v. Railway Co., 41 N.D. 381, 170 N.W. 568 (1918).

[57] *Cf.* Cincinnati, N.O. & T.P. Ry. v. Falconer, 30 Ky. L. Rep. 152, 97 S.W. 727 (1906); Cincinnati, C.C. & S.L. Ry. v. McKelvey, *supra* note 52.

[58] *Cf.* Olds v. Von der Hellen, 127 Ore. 276, 263 Pac. 907 (1928). Compare the treatment of this problem in fire-insurance cases, *infra* pp. 383–394; and in eminent-domain cases, Orgel, *op. cit.*, Chap. 16.

to testify to the extent of depreciation, either as a matter of opinion, or by comparison with a new building, or by a fixed rate considered by them to be appropriate. The opinions do not indicate any preference for one of these methods as opposed to any other.

In the light of these rulings on evidence, what, if any, is the practical difference between the above *verbal* standards of recovery? As between "actual value of the building" and the "fall in market value" of the whole property, no difference is clearly revealed by the cases; yet the possibility of different results must be recognized. Suppose, for example, that the plaintiff owns an almost worthless house which he lives in only until he receives a sufficiently high offer for the land. Under the "actual-value" test a jury might take into consideration the fact that the building was the plaintiff's home, although this fact was no longer of importance even to the plaintiff. As to reconstruction cost, we have already indicated some possible differences in result. The obvious difference lies in the probability that obsolescence, even if expressly mentioned as an element to be "considered," will be slighted where the general nature of the charge emphasizes the condition of a building and the expense of reproducing it as the important factors in the determination of the award. In general, the use of a reconstruction-cost test seems likely to result in higher awards.

On the other hand, there is some reason to believe that the fall-in-market-value test has equal dangers and that its rejection by several courts is due to the fear that the introduction of the value of the entire land as a factor in computing the award may open the door to inflated and not easily checked estimates of value. Thus, where full-grown timber is destroyed, some courts[59] insist that its value as timber marks the limit of recovery, in contrast to the position of other courts,[60] which allow recovery for the fall in value of the land. The same diversity of opinion is found in cases dealing with yielding crops.[61] On the other hand, ornamental or fruit-bearing trees or immature trees are usually of little value apart from the land, and here all courts[62] agree that the fall in value of the land measures the recovery.

Sometimes the choice between "market value of the destroyed property" and the "fall in value of the improved land" will be influ-

[59] Wooden-ware Co. v. U.S., 106 U.S. 432 (1882); Eldridge v. Gorman, 77 Conn. 699, 60 Atl. 643 (1905); Michigan Land & Iron Co. v. Deer Lake Co., 60 Mich. 143, 27 N.W. 10 (1886).

[60] Chipman v. Hibberd, 6 Calif. 162 (1856); Striegel v. Moore, 55 Iowa 88, 7 N.W. 413 (1880).

[61] Sedgwick, *Damages*, Vol. III, pp. 1936–1940.

[62] *Ibid.*, at 1924–1925.

enced by the court's views as to whether the destroyed property was realty or personalty. For example, where a plaintiff brought a replevin action to recover a fence removed from his land, the court[63] felt constrained to hold that the fence should be valued as personal property; that is, as an unattached fence. The plaintiff thereby lost the cost of attaching the fence, which he would have recovered had he sued for the injury to his real estate.

In the cases heretofore considered, the owner of the building also owned the land. When the land belongs to someone else, interesting valuation questions arise. The usual case involves a building erected by a tenant for a term of years, with or without the right to remove at the end of the period. Where the tenant has the right to remove the building, the courts have stated that the owner of the fee has no interest in the building.[64] This is not true, because the owner is in an advantageous position to purchase the building at the end of the term. To the extent that he has a factual ability to purchase for less than the value of the building to him, he benefits by the continued existence of the building.[65] If the owner of the fee is responsible for the tenant's inability to remove the building, thereby converting it, there is a tendency on the part of the courts[66] to award

[63] Pennybecker v. McDougal, 48 Calif. 160 (1874). In Rhoda v. Alameda County, 58 Calif. 357 (1881), the defendant removed a vault from the plaintiff's building. The trial court instructed the jury to find the market value of the vault. The appellate court reversed, holding that the value of the vault in place as part of the realty, and not the sum for which it would sell after removal, was the proper measure of damage. But here the defendant was appealing, and the import of the holding is not clear.

[64] Eten v. Luyster, 60 N.Y. 253 (1875).

[65] Two other benefits might be mentioned. There is a likelihood of a renewal of the lease at a rental better than could be obtained from one who had no building there. There is also a greater assurance that the rent will be paid so long as the building remains in existence.

In McPhillips v. Fitzgerald, 76 App. Div. 15, 78 N.Y. Supp. 631 (1902), *aff'd*, 177 N.Y. 543, 69 N.E. 1126 (1904), plaintiff was a tenant with a right to remove a building at the end of the term of the lease, which had only a short time to run. The building was negligently destroyed by the defendants. The court held that it was proper for the jury to consider the fact that it was the established custom of the lessor, a religious corporation, to grant renewals to the owners of buildings.

[66] Neiswanger v. Squier, 73 Mo. 192 (1880); see Ladd v. Hawkes, 41 Ore. 247, 68 Pac. 422 (1902). *Cf.* Bruce v. Welch, 52 Hun 524 (N.Y., 1889), involving mantel and grates, where the court awarded the value in place on the ground that defendant should not profit by his own wrong. Sedgwick says (*Damages*, Vol. III, p. 2069, n. 134): "It would seem that the plaintiff's actual loss was the value before severance, since he could sell them at that valuation to the landlord or to an incoming tenant." But the implication that the "value before severance" is the

to the tenant the entire value of the building to the fee owner, on the theory that he is unjustly enriched to that extent. The measure of that enrichment is usually exaggerated by the courts, for they conceive the enrichment to consist of the value of the building as an improvement rather than as the price which the tenant would have been willing to accept. The minimum amount which the tenant would presumably have accepted would be the scrap or removal value of the building. The maximum amount which he could hope to obtain would be the value of the building to the fee owner. The price that would be arrived at in a bargain is necessarily indeterminate.[67]

Where the fee owner destroys the building because of alleged failure to remove, the owner of the building should not recover more than its value when removed less the cost of removal.[68] The latter owner could not have obtained more for his building, since the actions of the fee owner indicate that he was not a possible purchaser.

Another problem raised by these cases concerns the place to which the building is to be removed. The courts often assume that the value of the building when removed, less the cost of removal, determines its value. But the cost of removal depends largely on the distance which the building must be moved. It is therefore surprising that, in one case,[69] plaintiff was not permitted to show that he owned adjacent land to which he could have removed the building. In this case a flood had washed the plaintiff's house onto the defendant's railroad right of way, and defendant had demolished the house. The appellate court, in reversing the trial court, merely said that the defendant's rights could not be affected by the fact that plaintiff owned land in the vicinity, although it purported to award the value of the house as it stood on the track, less the cost of removal. If the availability of land to which the building might have been removed was not to be considered, the plaintiff was entitled at most to an award of nominal damages, because the only determinate value of the building was then

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same as reproduction cost less depreciation is unwarranted, because neither person might give that amount, knowing that the outgoing tenant must sell or remove.

In Seibel v. Siemon, 72 Mo. 526 (1880), plaintiff purchased the building at a mechanic's lien sale, for purposes of removal. Defendant refused to permit the removal, and plaintiff was awarded only the value which the building would have had if removed. The court said: "The plaintiff has no right to measure his damages by the defendant's benefit."

[67] Compare the similar problem in eminent domain. Orgel, *op. cit.*, Chaps. 9–10.

[68] Heidelberg v. Newton, 292 S.W. 909 (Tex. Civ. App., 1927).

[69] Ohio Valley Ry. Co. v. Scott, 172 Ky. 183, 189 S.W. 7 (1916)

its scrap value, and the defendant had deposited the scrap on plaintiff's land after demolishing the building.

In contrast with the last case is the action of the California court in *Barrante v. Garratt.*[70] The plaintiff had erected a building on leased land, with the privilege of removal at the end of the term. The landlord, who owned the surrounding land for about 3 miles, prevented the removal at the end of the term. The country was rough, and the cost of removing the building beyond the landlord's land would have exceeded its value when removed. The depreciated reproduction cost was estimated at $500; the value "to a person desiring a building of that character and having the right to use it where located" was estimated at $400; and the net scrap value was set at $150. The trial court awarded $200 as the market value, which was affirmed on appeal by the tenant. It does not appear what the trial court meant by "market value." If it meant the value to the defendant (ignoring what the plaintiff might have been willing to accept), its award would indicate that the court thought that the defendant would have been unwilling to pay more than $200, although someone else in his position might have paid as much as $400 for it. It is more likely, however, that the court thought of "market value" as a price which the defendant would have been justified in paying, and the plaintiff in accepting, and that a premium to the plaintiff of $50 more than the net scrap value would have been all that the plaintiff could or should have obtained.

The same problem is presented where the landlord refuses to permit a tenant to remove trade fixtures at the end of the term. Several New York cases[71] have held that the tenant's recovery is limited to the net salvage value, that is, value when removed less cost of removal. The courts were of the opinion that this was all that the plaintiff had lost, and that any excess would represent value to the defendant, which was said to be immaterial. Contrary decisions in other jurisdictions[72] award what appears to be reproduction cost less depreciation. These decisions, as a rule, rest on the doctrine of unjust enrichment.

F. Ships.

Practically every problem in the valuation of ships is illustrated by *Standard Oil Co. v. Southern Pacific Co.*,[73] involving the valuation of the

[70] 50 Calif. 112 (1875).

[71] Johnson v. Albany Dry Goods Co., 12 App. Div. 608, 43 N.Y. Supp. 164 (1896); see also Meier v. Wilkens, 15 App. Div. 97, 44 N.Y. Supp. 274 (1897); Levenson Wrecking Co. v. Hillebrand, 93 Misc. 530, 157 N.Y. Supp. 515 (1916). These cases apparently overrule Bruce v. Welch, *supra* note 66.

[72] *E.g.*, Updegraff v. Lesem, 15 Colo. App. 297, 62 Pac. 342 (1900).

[73] 268 U.S. 146 (1925).

ship *Proteus*, which was sunk on Aug. 19, 1918, in a collision with the steamship *Cushing*. The action was brought in the United States District Court for the Southern District of New York, and the court appointed a commissioner to determine the value of the ship. The evidence showed that, in August, 1918, all American ships of the size and type of the *Proteus*, including the *Proteus* herself, and all shipyards, were under requisition by the government. Few ships of any kind were available, and there was a resulting "time monopoly" in ships. The cost of construction had increased to two and a half or three times pre-war cost, due to the unprecedented demand and to the shortage of facilities and yards. The prices demanded by shipowners had soared beyond even the then cost of constructing new ships. The witnesses for the owners of the *Proteus* testified that her cost of reproduction as a new ship in August, 1918, would have been about $1,750,000 and that not more than $525,000 should be deducted for depreciation because of the excellent condition of the ship and the vast appreciation due to the war demand. It appeared that the *Proteus* had been built in 1900 at a cost of $557,000, that in 1909 she was reboilered and otherwise improved at a cost of $90,000 and was in excellent condition for her age.

The witnesses for the petitioner testified respectively that the *Proteus* was worth $650,000, $633,000, $630,000, and $611,000. Some of them admitted that the cost of reproduction new would have been about $1,700,000, while others claimed that $1,400,000 was sufficient. They varied equally widely, but in the inverse order, as to the proper deduction for depreciation, with the resultant figures for the value of the ship which we have already stated.

The *Comus*, sister ship of the *Proteus*, was insured with the Bureau of War Risk Insurance for $690,000, but both the commissioner and the courts disclaimed any reliance on this fact.

The commissioner to whom the case was referred concluded that the ship was worth $750,000, on the basis of "actual value" rather than "market value." Both parties objected to the figure, but Judge Mack, before whom the report came up for confirmation, approved both the reasoning and the result. The rejection of market value he thought proper because,[74]

While the market price may be the fairest test of the value of standard commodities commonly bought and sold, when the normal conditions of competition have free play, this test obviously fails, *not only if there is no market*, but when the conditions which make the test a proper one do not obtain. (Italics ours.)

[74] The Cushing, 266 Fed. 570 (S.D. N.Y., 1920); 285 Fed. 617 (S.D. N.Y., 1920).

As an additional reason for rejecting market value, Judge Mack stated that, because the ship was under requisition, the price which might have been obtained by the owner of a free ship was immaterial. While this assertion may have been valid, its significance would have depended on the amount of compensation that was to be expected from the government. Conceivably the fact that she was under requisition might have added to her market value, just as condemned property will often sell for more than adjacent property.

Having eliminated "market value," Judge Mack proceeded to consider what he termed the "fair value." In his opinion, reproduction cost less depreciation would ordinarily show the fair value; but in 1918, as a result of the temporary national necessities, conditions with respect to the cost of reproduction had been influenced almost to the same extent as market value; hence neither was a criterion of "fair value." With these general principles as a guide, Judge Mack was apparently inclined to the view that *normal* reproduction cost less depreciation would represent a fair award. This may be gathered from the reasoning with which he rejected the contention that the commissioner's figure was too high. He stated that he, too, would have regarded the figure as too high by $75,000 to $100,000 were it not for the fact that the boat was in better condition than others of her age would ordinarily be, and therefore that the standard depreciation tables were inapplicable.

The Southern Pacific Company appealed to the Circuit Court of Appeals, which held[75] that the value of the *Proteus* was $1,225,000, chiefly on the evidence as to reproduction cost. The court thought that Judge Mack was not justified in ignoring the 1918 cost of reproduction on the theory that the prices were artificial and fictitious; since they actually prevailed at the time, these prices should be made the basis of the award.

A further appeal, by the owners of the *Cushing*, resulted in affirmance by the Supreme Court of the Circuit Court's judgment. The Supreme Court's impression of the testimony is indicated in the following passage: "We think the commissioner and District Court failed to give due regard to construction costs, conditions, wages and prices affecting values in 1918; and that the evidence sustains the decree of the Circuit Court of Appeals."

As to the applicable standard of value, the Supreme Court is no clearer than less illustrious courts. Justice Butler's opinion states:

> It is fundamental in the law of damages that the injured party is entitled to compensation for the loss sustained. Where property is destroyed by

[75] *Ibid.*, 292 Fed. 560 (C.C.A. 2d, 1923).

wrongful act, the owner is entitled to its money equivalent, and thereby to be put in as good position pecuniarily as if his property had not been destroyed. In case of total loss of a vessel, the measure of damages is its market value, if it has a market value, at the time of destruction. *The Baltimore*, 8 Wall. 377, 385. Where there is no market value such as is established by contemporaneous sales of like property in the way of ordinary business, as in the case of merchandise bought and sold in the market, other evidence is resorted to. The value of the vessel lost properly may be taken to be the sum which, considering all the circumstances, probably could have been obtained for her on the date of the collision; that is, the sum that in all probability would result from fair negotiations between an owner willing to sell and a purchaser willing to buy. *Brooks-Scanlon Corporation v. United States*, 265 U.S. 106, 123. And by numerous decisions of this court it is firmly established that the cost of reproduction as of the date of valuation, constitutes evidence properly to be considered in the ascertainment of value. *Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276, 287 and cases cited; *Bluefield Co. v. Public Service Commission*, 262 U.S. 679, 689; *Georgia Railway & Power Co. v. Railroad Commission*, 262 U.S. 625, 629; *Brooks-Scanlon Corporation v. United States, supra* 125; *Ohio Utilities Company v. Public Utilities Commission*, 267 U.S. 359. . . . It is to be borne in mind that value is the thing to be found and that neither cost of reproduction new, nor that less depreciation, is the measure or sole guide. The ascertainment of value is not controlled by artificial rules. It is not a matter of formulas, but there must be a reasonable judgment having its basis in a proper consideration of all relevant facts. *Minnesota Rate Cases*, 230 U.S. 352, 434.

So strikingly do the above quoted sentences summarize the philosophy of the Supreme Court, and of other American courts, on the valuation of property for the purpose of measuring damages, that they warrant close and critical analysis. Three points require emphasis: (*a*) the questionable assumption that an award of market value necessarily gives complete indemnity for pecuniary loss; (*b*) the definition of the term "value"; and (*c*) the treatment of the evidence. But the first point needs no further comment, since it has been discussed at length in the preceding chapter.

As to the definition of "value," the opinion leaves open two questions that, while of purely academic interest in the instant case, are of practical importance in other legal appraisals. In the first place, does Justice Butler's distinction between market value (which must be accepted if the property *has* such a value) and probable selling price (the alternative criterion) imply a distinction between two *standards* of value, or merely between two *measures* of value? That is to say, we are not informed whether market value is the preferred criterion because it is deemed to be the best index of the price at which the owner

himself could have sold his property, or whether it is a superior, independent standard, to be accepted on its own merits. In some cases, the answer to this question will affect the definition of "market value" itself. This is notably true with respect to property held in large quantities, which could not be sold except at a material discount from the quoted market price per unit of smaller lots. We shall refer to this problem in Chaps. XXI (on death-tax valuations) and XXIX (on income-tax valuations). In the second place, why did Justice Butler assume that the owner of the ship, as of the date of the collision, could in fact have sold her for a sum equal to the price that would result from fair negotiations between a "willing buyer" and a "willing seller"? We *surmise* that the Justice was here using the familiar "willing-buyer, willing-seller" incantation merely in order to import the idea of a leisurely, well-negotiated sale, in which the seller would have full opportunity to go shopping for the best bidder. But not all judges have used the phrase in this narrow sense. Some of them have conjured up a purely mythical "willing buyer," even when they have been well aware that no such buyer was in existence. As noted in Chap. III (on the meaning of market value), they have done this in order to make their verbal allowance of a mere "market value" correspond to the special value of the property to the owner himself.

As to the problems of evidence, three points are of outstanding interest: (*a*) the reliance placed upon the "spot" reproduction cost; (*b*) the unusually small deduction for depreciation; and (*c*) the readiness of the two higher courts to disregard the fact that the ship was under requisition.

In defense of a valuation based largely on reproduction cost, the Supreme Court relied on the precedents of its prior decisions. With the single exception of the *Brooks-Scanlon* case, which involved the determination of "just compensation," the only cited American cases were rate cases. Yet, in these cases, in which the Court has often been divided, even the prevailing opinions have not accepted either "market value" or probable selling price as the pertinent standard. Of course, reproduction cost may be good evidence of different kinds of value. But in that event, the theories of relevance must necessarily differ, and a ruling in one field is hardly a persuasive precedent for a similar ruling in another field. Even on their face, the rate cases are hardly citable as authorities for the acceptance of a "*spot*" reproduction cost which, in the *Proteus* case, was conceded to have been highly "abnormal." While the Court has not been entirely clear on the issue, it has distinctly implied that, in rate cases, the pertinent reproduction cost is a normal or an enduring cost—one that may be expected

to persist over a considerable period of time subsequent to the date as of which the valuation is being made.[76]

As to the second problem of evidence, the treatment of depreciation, the two higher courts were doubtless justified in their defence of a relatively small deduction. The government's dire need for ships minimized the difference between the value of a new ship and the value of an old one. The old ship was quite serviceable for emergency use, and the fact that a newer ship might have outlasted it was relatively insignificant.

But this last circumstance made all the more important the third point at issue—the fact that the ship was already under requisition and hence would not have been available for use by a private owner until the government should see fit to release it. To a private owner, therefore, the ship had become, in effect, a mere opportunity to secure compensation from the government together with an opportunity to recapture the ship at some uncertain time in the future, when the market for ships would have become glutted owing to the cessation of the war. Judge Mack mentioned the requisition as constituting one of the reasons why the market-value standard was inapplicable. But the Circuit Court of Appeals dismissed the point on the purely legalistic ground that the sinking of the vessel ended the right of the government. On this issue the Supreme Court made no comment.

The foregoing remarks should not be taken to imply a criticism of the *results* of the decision when judged in the light of the traditional rule in property-damage cases, under which the damages must be measured as of the time when the injury took place. Estimated as of that date, not only the loss imposed upon the ship owner, but also the *value* of the ship, under any significant definition of "value," was indeterminate. Valuation, as well as loss determination, involves prophecy; and when the future is as uncertain as it was on the date of the collision the prophecy must be either an intelligent guess or an act of clairvoyance. None of the three courts concerned in the *Proteus* case claimed the power of clairvoyance; and as to their guessing ability, the judges may well have been quite as competent as the most expert, professional appraiser. But if these courts thought of their actions as that of a guessing game, they did not take the public into their confidence. On the other hand, if they thought that they were applying a purely mechanical measure of damages, they were disregarding Justice Butler's pronouncement that "the owner is entitled to be put in as good a position pecuniarily as if his property had not deen destroyed."

[76] *Infra* pp. 1121–1124.

While the other ship cases add little of importance to the *Proteus* case, several of them justify a brief comment.

In *The Benjamin A. Van Brunt*,[77] a large number of schooners were lying idle because of low freight rates and excess supply of sailing ships. This was in 1921, when there was an excessive tonnage due to the sudden cessation of demand as a consequence of the Armistice. There were few sales, all of them "distress sales"; owners who could do so retained their vessels in the hope that conditions might improve. A commissioner appointed to fix the value found that there was no market value and calculated the amount based upon the vessel's probable earning power. The court reversed, saying that, while it could appreciate the difficulties of determining a market value, nevertheless, the evidence was sufficient to show that one existed.

In *The I. C. White*,[78] the destroyed vessel was especially designed for use in shallow water, and the owner could not find another precisely like it in the market. The commissioner decided that, in view of these facts, the market value of other craft of the same general class and employed in the same trade was irrelevant, and awarded reproduction cost less depreciation. But the evidence showed that there was a lull in the shipping market and an extreme fall in prices. The court refused to confirm, holding that the market value should be awarded, based on the cost in the market of a vessel which could serve the same purpose, but with an adequate allowance for the superior worth of the destroyed vessel.

In *The H. F. Dimock*,[79] the yacht *Alva*, owned by William K. Vanderbilt, was destroyed in a collision with the *Dimock*, and it was necessary to determine her value. The vessel was 5 years old and had been constructed at a cost of $400,000. There was testimony to the effect that she could have been reproduced new for 15 per cent less than original cost. Vanderbilt testified that she was worth $250,000 to him. Commissioners placed the value at $190,000, based chiefly upon original cost minus an allowance for depreciation. The district judge affirmed on the ground that the evidence showed that the value found by the commissioners was the market value. The Circuit Court, to which the owner of the *Dimock* appealed, likewise affirmed but said that market value was not the criterion. With property of the kind here involved, market value was not a fair test; the "value to the owner" was the measure of the award. Even this value, however, did not include sentimental value, and therefore

[77] 3 F. (2d) 655 (E.D. Pa., 1925).
[78] 295 Fed. 593 (C.C.A. 4th, 1924).
[79] 77 Fed. 226 (C.C.A. 1st, 1896).

Vanderbilt's testimony as to what the yacht was worth to him was properly ignored.[80]

G. Secondhand Consumers' Goods.

Secondhand markets exist for many kinds of articles; household goods, clothing, and automobiles are regularly bought and sold therein even though prices are not highly standardized. Some concept of market value might therefore seem applicable to damage suits involving such property, either in the sense of replacement cost or of selling price.

However, the practical objections to a market-value standard in this field are patent. For numerous reasons, goods in the hands of a user have a special worth to him that is not reflected either in the selling price or in the cost of replacement in a secondhand market. Courts readily reject the market-value concept as applicable to this type of property. In most cases, the courts not only permit the jury to find a value other than the secondhand buying or selling price, but even exclude evidence of the existence of a secondhand market.

In *Birmingham Light & Power Co. v. Hinton*,[81] the court brusquely said that "the value should be fixed or estimated in some rational way, other than showing what they would bring in a particular market or if hawked off by a secondhand dealer." The usual formula, however, is to say that no market exists for the particular piece of used property, apparently because there is not an organized group of buyers and sellers, and that resort must therefore be had to "actual value" or "value to the owner."[82] Sometimes a court[83] will say that "market value" is *never* anything more than mere *evidence* of "value," and that here its evidential force is small. The following statement is typical:[84]

Wearing apparel in use and household goods and effects owned and kept for personal use, are articles which cannot in any fair sense be said to be mar-

[80] See, also, on ship valuation, The Granite State, 70 U.S. 310 (1865); The Transit, 4 Ben. 138, Fed. Cas. 14138 (1870); The Emilie, 4 Ben. 235, Fed. Cas. 4451 (1870); Blanchard v. N.J. Steamboat Co., 59 N.Y. 292 (1874); The City of Alexandria, 40 Fed. 697 (1889); The J. E. Trudeau, 54 Fed. 907 (1893); Rand v. Lockwood, 16 F.(2d) 757 (C.C.A. 4th, 1927); Leonard v. Whitwill, 19 Fed. 547 (1884).

[81] 157 Ala. 630, 47 So. 576 (1908).

[82] Lake v. Dye, 232 N.Y. 209, 133 N.E. 448 (1921).

[83] Wall v. Platt, *supra* note 55.

[84] Lake v. Dye, *supra* note 82. Even here there is not entire unanimity. In Worrall v. Grocers Association, 157 Iowa 385, 138 N.W. 481 (1912), defendant offered to show an organized retail market and asked that the jury be instructed that, if they believed such a market existed, they should award the retail value in that market. A refusal to give this instruction was held error.

netable, and have a market value, or at least a market value which is fairly iudicative of their real value to the owner, and of his loss by being deprived hof tem. Where such articles have been converted, the amount of recovery koght not to be restricted to the price which could be realized by a sale in the market. The owner should be allowed to recover the value to him based on his actual money loss, all the circumstances and conditions considered, resulting from his being deprived of the property, not including, however, any sentimental or fanciful value he may for any reason place upon it.

The rejection of secondhand sale value does not of itself indicate the measure of recovery. Excluding sentimental or capricious reasons, which the courts ignore in these cases, the award should not *exceed* the cost of replacing with new articles, unless the delay of replacement would impose serious "incidental" loss upon the owner. But an award of replacement cost new would often overindemnify, just as secondhand market values would underindemnify; therefore an allowance is generally made for depreciation.[85] Depreciation, however, is not fixed according to any mathematical, or even reasonably careful, process; evidence of the amount of the use is held sufficient to indicate to the triers of the facts the necessary discount. Similarly, while replacement cost rather than original cost is the basis, proof of the original cost,[86] together with evidence of the amount of the use, will be sufficient evidence for the plaintiff of the amount of the damage suffered. This will usually be explained by the courts on the ground that the original cost is evidence of the replacement cost, and that the *defendant* may introduce such countervailing evidence as he chooses. It is more likely, however, that the object of this ruling is to relieve the plaintiff of the expense of procuring expert testimony, or, at least, not to dismiss his claim when he has failed to procure it.

While capricious or sentimental reasons for attachment to a particular article are disregarded, the plaintiff is not penalized because he selects styles unpopular with others. In *Gold v. Rousso*,[87] the plaintiff sued for loss of a raglan overcoat, which had been made to his measure at a cost of $125, and worn only five or six times. The defendants

[85] Cases involving secondhand goods: Sell v. Ward, 81 Ill. App. 675 (1899); Schall v. Northland Motor Co., 123 Minn. 214, 143 N.W. 357 (1913); International and G.N. Ry. v. Nicholson, 61 Tex. 550 (1884); Denver, S.P. & P.R.R. v. Frame, 6 Colo. 382 (1882); Barker v. Lewis Co., 78 Conn. 198, 61 Atl. 363 (1905); (same), 79 Conn. 342, 65 Atl. 143 (1906).

[86] Proof of original cost is so common in this type of case that in two opinions the courts seem to have thought of the measure of recovery in terms of this cost. McMahon v. City of Dubuque, 107 Iowa 62, 77 N.W. 517 (1898); Jacksonville Co. v. Peninsular Land Co., *supra* note 56.

[87] 238 Ill. App. 427 (1925).

produced a witness who testified that he was a dealer in such coats and that they were a drug on the market, obtainable at half their cost of manufacture. The trial court ignored this testimony and awarded $100 as the equivalent of cost less depreciation. The appellate court treated the case as one of a conflict in testimony which it was not warranted in disturbing. Neither court mentioned the absence of any close relationship between the price of ready-made garments and one made to measure.

Where the plaintiff is not a user, the reason for the rejection of secondhand market value fails to apply. For example, a dealer in furniture sold merchandise to *X* on the installment plan, retaining title until the full price should have been paid. *X* wrongfully sold the furniture to *Y*, and the dealer, upon learning of it, sued *Y* for its value. The "value," it was held,[88] was what the dealer could have realized for the furniture in the secondhand market. The reason given by the court was that all the dealer could do with the furniture would be to resell it at this figure.

H. Securities "Having No Market Value."

Most of the case law on the valuation of inactively marketed securities is to be found in the field of taxation; and we therefore treat the subject at length in the chapters on the death taxes (Chap. XXI) and on income taxation (Chap. XXIX). Nevertheless, some of the cases arising under the law of damages are worth noting. In this latter field, though seldom in taxation, inactive securities are sometimes said to "have no market value," and a determination of their "real" or "true" value is called for. But despite this verbal difference, the methods of valuation are essentially the same in both branches of law.

Where there has not been sufficiently active trading to establish a "market value," the prices obtained on desultory sales may nevertheless be given consideration; they are evidence, but not conclusive. In *Deck v. Feld*,[89] the plaintiff sold to the defendant two shares of stock of a Fair Association, par value $100, without agreement as to price. There had been scattered sales at from $40 to $100 per share. Shortly after the sale, the Association reversed its policy of maintaining its valuable properties for the communal benefit, and sold them. As a result, it realized about $800 per share for distribution in liquidation. The court found the sales sufficiently numerous to establish a market value, and it therefore reversed a verdict for $800 per share, which

[88] O'Neill v. Patterson, 26 Misc. 3, 55 N.Y. Supp. 617 (1899).
[89] 38 Mo. App. 674 (1889).

might have been affirmed if the court had found that no market value existed for the shares, with a consequent justification for a resort to a valuation of the corporate assets.

What is meant by "valuation of the assets"? In the important case of *Virginia v. West Virginia*,[90] the Supreme Court of the United States accepted book value as indicative of asset value. This does not, however, prove any great enthusiasm on the part of that Court for book-value figures; the case was one requiring valuation of certain southern railroads as of just before the Civil War, and the book figures were the best obtainable.

Wherever current appraisal values can be obtained, they are preferred by the courts to book values.[91] The corporate liabilities are of course deducted from gross assets in the process of determining net asset value.[92] The liquidation value of the corporate enterprise has been ignored in the ascertainment of its value, all of the cases having dealt with going concerns. Thus, it has been held that, where a corporation was temporarily embarrassed by the defalcation of one of its officers, so that a sale of its assets at that time would not have realized enough to pay anything on the common stock, that fact was not conclusive that the stock was worthless at the time, since the corporation was engaged in a lucrative business.[93]

Ordinarily, value of the corporate assets is considered, not by itself, but in conjunction with the record of corporate prosperity.[94] The latter record should preferably be established by net earnings, but in the cases where earnings records were unavailable or where exactness was not important, dividends have been used. In *Virginia v. West Virginia*, previously cited, the Supreme Court sustained the special master's valuation of the shares at the arithmetical average of book value and of capitalization of annual dividends, capitalized at 6 per cent. Such mechanically exact averaging is unusual.

In the general run of cases, little can be discerned as to the way in which the court deals with the earnings or dividends. The opinion merely indicates that this evidence, together with all other evidence in

[90] 238 U.S. 202 (1915), also noted *infra* p. 1055.

[91] Leavitt v. Lusch, 192 Ill. App. 504 (1915); *cf.* Darling v. Bradstreet, 113 Me. 136, 93 Atl. 50 (1915).

[92] Morgan v. Johns, 84 Ore. 557, 165 Pac. 369 (1917).

[93] Gorham v. Massilon Iron & Steel Co., 209 Ill. App. 606 (1918); Feige v. Burt, 124 Mich. 565, 83 N.W. 367 (1900). See Hawkins v. Mellis, 127 Minn. 393, 149 N.W. 663 (1914).

[94] McDonald v. Danahy, 196 Ill. 133, 63 N.E. 648 (1902); Industrial & General Trust v. Tod, 170 N.Y. 233, 63 N.E. 285 (1902); (same) 180 N.Y. 215, 73 N.E7. (1905).

the case, had been "considered" and "given some weight." When it is remembered that the "other evidence" may include such diverse facts as value of the tangible assets, par value of the shares,[95] rabitrary rules of thumb of so-called experts,[96] scattered sales and offers, one must recognize the extreme crudeness of the valuation.

In some cases, however, instead of vague statements that earnings have been "considered," we find a well-defined technique for capitalizing the realized corporate earnings. The method has been worked out in the decisions of the New York courts, of which *Von Au v. Magenheimer*[97] is the leading case. The method, which may be described briefly as the capitalization of excess earnings, was originally resorted to as a means of checking the reasonableness of a jury verdict. In New York, however, it has advanced to the dignity of the standard method of determining the value of shares of stock in close corporations, and of good will generally. Discussion of this method is omitted here, because the problem occurs most frequently in connection with taxation and is considered at length in later chapters on that subject.[98]

I. Speculative Chances.

In Chap. XI, on capitalized income as a measure of value, we discussed a prevailing economic theory that the values of all forms of wealth, without exception, are merely discounted valuations of the future services which the wealth is expected to confer upon its possessor. With various qualifications, this theory is now fairly generally accepted in the economics profession; and it has won widespread acceptance in the appraisal professions, though not in popular thinking.

But there are certain forms of wealth to which the theory seems so obviously applicable, that it has received almost universal recognition even by persons untrained in value theory. To this category of property belong such items as stock options, lottery tickets, and other prospects of happy events that do not lend themselves to the popular myth that property has an "inherent," or "intrinsic" value. When

[95] The justification for paying attention to par is not easy to see; nevertheless, courts occasionally pay attention to it. Hawkins v. Mellis, *supra* note 93; *contra* Beaty v. Johnston, 66 Ark. 529, 52 S.W. 129 (1899); Hussey v. Flanagan, 237 N.Y. 227, 142 N.E. 594 (1923). On par value as proof of "fair market value" of shares for tax purposes, see *infra* pp. 1054–1056.

[96] For example, in Brinkerhoff-Farris Trust & Savings Co. v. Home Lumber Co., 118 Mo. 447, 24 S.W. 129 (1893), a broker testified that a stock which consistently earns 9 per cent dividends is worth par.

[97] 115 App. Div. 84, 100 N.Y. Supp. 659 (1906), *on second appeal*, 126 App. Div. 257, 110 N.Y. Supp. 629 (1908), *aff'd*, 196 N.Y. 510, 89 N.E. 1114 (1909).

[98] See *infra* pp. 595–611, 727–735, 1060–1073.

they are thought of as having any value at all, their value is envisaged in terms of a discounted chance of gain.

Sometimes, chances of this nature have a fairly well-established market price. In that event, the market-value test is as applicable as it is to more familiar types of property. Thus, puts, calls, and straddles have been made the subject of damage awards, based on current price quotations or on expert testimony.[99]

Other chances, however, are more difficult to evaluate. In an English case,[100] a prize had been offered for the best model of a machine, and the plaintiff's entry had been destroyed in transit. The court awarded the cost of the labor and materials expended on the model, stating that the chance of obtaining the prize was too remote to be valued. This type of ruling was disapproved in a later case in Pennsylvania,[101] where the court awarded nominal damages only, on testimony by a member of the prize committee that plaintiff's model would have failed.

These cases illustrate two ways by which the courts have met the problem of "speculative damages." Difficulty in estimating the amount led to almost complete exclusion in the Pennsylvania case, whereas it led to an arbitrary allowance in the English case. In another English case,[102] where fifty girls had been selected by readers' votes as candidates for prizes, the plaintiff had been given no opportunity to appear, although she was one of the fifty selected. An award of £100 by a jury was allowed to stand by the trial court and sustained on appeal.

In some cases the courts are actuated by considerations other than the mere difficulty of appraisal. The plaintiff owns land supposed to contain oil, and which therefore commands a high market price. The

[99] See Vroom v. Sage, 100 App. Div. 285, 91 N.Y. Supp. 456 (1905), *aff'd*, 184 N.Y. 542, 76 N.E. 1111 (1906).

[100] Watson v. Ambergate, N. & B. Ry., 15 Jur. 448 (Q.B., 1851).

[101] Adams Express Co. v. Egbert, 36 Pa. 360 (1860).

[102] Chaplin v. Hicks, 27 T.L.R. 244 (K.B.D., 1911), *aff'd*, 27 T.L.R. 458 (App. Ct., 1911). *Cf.* Sapwell v. Bass [1910] 2 K.B. 486. Another profitable comparison is between World's Columbian Exposition v. Pasteur-Chamberland Filter Co., 82 Ill. App. 94 (1899), and Stevens v. Yale, 113 Mich. 680, 72 N.W. 5 (1897). In the former, plaintiff sued for breach of a contract permitting him to advertise his patent filter by means of signs attached to drinking places at the World's Fair. His witnesses testified as experts concerning the "market value" of the advertising space. The only apparent basis for their testimony was the probable earnings to be anticipated from the advertising. But the plaintiff shrewdly procured testimony in terms of "value," and recovered. In the latter case, on somewhat similar facts, plaintiff attempted to show his probable profits and lost on the ground that the damages were speculative.

defendant enters upon the land unlawfully and digs a well, revealing that there is no oil. In this situation, some courts[103] award the difference between the selling prices before and after the trespass. Other courts,[104] however, actuated by a feeling of the impropriety of selling for a large sum land ultimately proving to be worthless, award no more than nominal damages. Of considerable theoretical interest would be the judicial valuation of lottery tickets and similar chances, but we have found no reported case in point.

The term "speculative damages," as used in the opinions, covers such a wide variety of subjects that it does not lend itself to generalization. In connection with loss of resale profits, and in other cases, we have instances of judicial discussion in terms of the speculativeness of the damages. On the whole, the attitude of the English court in the model case is typical. Where there is available a ready alternative to the valuation of the chance or opportunity, the alternative is likely to be resorted to. Sometimes the alternative measure of damages may be substantially less than the amount of the probable loss, as in an award of wholesale replacement prices to a retail dealer who has been deprived of his entire stock of merchandise. Sometimes the award will exceed the more probable loss, as in the mulberry-tree case previously discussed.[105] Here the trees were lost by the carrier shortly before they were recognized as worthless. The award was the market price at the time of the loss, although it seems probable that the plaintiff farmer would not have sold his trees in time to shift the loss to another buyer.

V. Miscellaneous Value Problems.

A number of valuation problems in the law of damages are not conveniently discussed in terms either of the type of plaintiff or of the type of property. Some of these problems will now be considered.

A. *Sentimental Value.*

It appears to be a universal doctrine, not confined to the laws of damages and of eminent domain, that in the legal valuation of property, no allowance may be made for "sentimental value." No precise line of distinction between a sentimental and a non-sentimental value has ever

[103] *E.g.*, Humble Oil & Refining Co. v. Kishi, 276 S.W. 190 (Tex., 1925), *set aside on rehearing*, 291 S.W. 538 (Tex., 1927).

[104] Martel v. Hall Oil Co., 36 Wyo. 166, 253 Pac. 862 (1927); Campbell v. Smith, 180 Ind. 159, 101 N.E. 89 (1913).

[105] Smith v. Griffith, 3 Hill 333 (N.Y. 1842). See *supra* p. 288.

been established. We have already noted[106] that the courts have sometimes used "pecuniary value" as if it were antithetical to "sentimental value." But this antithesis is clearly false, unless one denies any pecuniary value to property which is not the source of a *money* income.

As used by the courts for the purpose of tabooing a particular claim for a money award, "sentimental value" seems to have been given the following connotations, sometimes separate and sometimes combined. Often "sentimental" is associated with "fanciful." Thus, we might say that the value of horse chestnuts when kept in one's pockets as a means of warding off colds is a purely "sentimental value." Here the claimed value may be disallowed because it is deemed nonexistent in fact. Sometimes, the value is thought of as really existing but as being due solely to the irrational, unreasonable, or abnormal attitude of the owner of the property. An example in point would be the "foolish" preference of an automobile owner for an out-of-date model, concededly inferior in design, comfort, and esteemed beauty. Here, the value may be excluded because, while its existence is undenied, it may be ignored by the law just as immoral or illegal values may go unprotected. But sometimes the sentimental value is conceded, not merely to have factual existence, but also to exemplify a thoroughly normal and proper attitude of mind on the part of the valuer. In this event, its peculiar nature must be found in the fact that the owner has special emotional attachments to the valued object, which cause him to cherish it without reference to those standards of serviceableness and replaceability that are implicit in the technique of the commercial appraiser. The deceased parent's portrait, the wedding ring, and the family homestead, are examples of property for which sentimental values may be claimed without necessarily invoking either ridicule or scorn from a judge or juryman.

We need not be surprised that claims to sentimental value which can plausibly be explained away as "fanciful" or as "unreasonable" have received short shrift from the courts. Indeed, the furniture and secondhand-clothing cases in which the plaintiffs have vainly made such claims can be accounted for on this ground. Of more interest are these cases in which the rule against sentimental value has been adhered to, verbally at least, despite plausible grounds for assuming that the claim is genuine and "reasonable."

Commentators on this aspect of the law of valuation have explained the harsh rule primarily, at least, on the strictly practical ground that the *amount* of sentimental value is simply not susceptible of proof. With rare exceptions—as where the owner of the property can establish

[106] *Supra* pp. 87–91.

the fact that he definitely rejected a recent bid at a given price—the only evidence is the word of the owner himself. Needless to say, any such testimony is so highly biased that it would probably be excluded on this ground alone.

But, as noted in Chap. IV, the doctrine against the allowance of sentimental value is by no means invariably taken as literally as its words would seem to require. Where the sentiment is shared by other people to the extent that it affects the *market value* of the property, the courts do not require that such value be discounted to what it would presumably be, were the sentiment to disappear. It is at most a claim for something *more* than market value which is disallowed under the rule. Moreover, even with types of property that are said to "have no market value," the courts have by no means invariably restricted the owner to the nominal damages that would often be required by a strict interpretation of the rule against sentimental value.

The family-portrait cases illustrate this last point.[107] The owner of the picture, no matter how worthless it is in the eyes of the world, can recover substantial damages for its destruction, based generally upon what the picture cost and on the expense and practicability of replacing it. To be sure, the courts will not allow the owner to testify to what the portrait is worth to him by reason of its associations. But it is obvious that, if the owner recovers anything at all, it must be because of its associational or sentimental value; and this is tacitly conceded by the courts when they permit the plaintiff to say that he has no other portrait.

The original cost of such a painting bears little enough relation to the injury which the owner sustains by being deprived of it. If there were any accurate measure of injury to the sentiment, the loss of a wretched old chromo of one's mother might be made the basis of a far larger award than the loss of an excellent oil painting of a detested great-aunt. But even when basing damages on cost, the courts are recognizing, albeit crudely, a value based upon sentiment; and it is probable that juries attempt to measure the value, although with like crudeness, by taking into account the closeness of the kinship.

Family portraits are not the only type of property for which a value based on sentimental considerations is allowed, in effect. Usually, however, the allowance is concealed by an arbitrary measure of dam-

[107] Green v. Boston & Lowell R.R., 128 Mass. 221 (1880); Houston & T.C.R.R. v. Burke, 55 Tex. 323 (1881); Ladd v. Ney, 36 Tex. Civ. App. 201, 81 S.W. 1007 (1904); Suydam v. Jenkins, 5 Super. 614, 3 Sandf. 614 (N.Y. 1850). See also cases cited by McCormick, *Handbook on the Law of Damages*, pp. 169–170, some of which disallow consideration of sentimental value.

ages which does not purport to measure the sentimental injury. For example, where a plaintiff brought suit for the loss of negatives of pictures which he took on a trip abroad, the court[108] recognized that, poor as the pictures might have been from a technical standpoint, they were worth more to the traveler than excellent inexpensive reproductions in the *National Geographic Magazine;* "that when one has gone a long way to obtain photographs of the scenery of a foreign land which it is difficult to reach, or where the photograph is of some incident that is not likely to be repeated, even a poor representation may be of considerable value"—in this case, $900.[109]

The evidence in *Bateman v. Ryder*[110] is thus summarized by the court:

> The testimony shows that the four pictures were oil paintings bought in Italy by the plaintiff's husband at a cost of $500, and presented to her while traveling, and were valuable intrinsically as well as from association; that the original cost of the guitar was $50, and it was highly prized for its associations; that there was considerable clothing in the trunk, besides a lot of manuscript productions, in prose and verse, of plaintiff's husband, which had never been published and probably could not be reproduced. There is evidence, on the other hand, that the pictures were not well preserved, that their frames were dilapidated; that they would probably bring about $20 at auction, and that the guitar would perhaps sell for $5; that the clothing was worn and old and of no real value; and that the manuscripts were of no value whatsoever.

A verdict of $200 was sustained.

B. Manipulated or Abnormal Market Prices.

It is a nice question whether the transaction involved in the leading case of *Kountz v. Kirkpatrick*[111] was illegal. Apparently the court did not regard it as so improper as to refuse any damages for the breach of the contract there involved. The force of the judicial condemnation expended itself entirely in the determination of the amount of the award.

The plaintiff sued for breach of a contract by which the defendants agreed to deliver, before the end of 1869, 2,000 barrels of oil at 13½ cents per gallon. The defendants showed that the plaintiff

[108] Wamsley v. Atlas Steamship Co., 50 App. Div. 199, 63 N.Y. Supp. 761 (1900), *rev'd on other grounds*, 168 N.Y. 533, 61 N.E. 896 (1901).

[109] How the figure was reached is not shown in the opinion.

[110] 106 Tenn. 712, 64 S.W. 48 (1901). See also Southern Express Co. v. Owens, 146 Ala. 412, 41 So. 752 (1906); Leoncini v. Post, 13 N.Y. Supp. 825 (1891); Disbrow v. Tenbroeck, 4 E.D. Smith 397 (N.Y., 1855); Missouri, K. & T. Ry. v. Dement, 115 S.W. 635 (Tex. Civ. App., 1909).

[111] 72 Pa. 376 (1872).

had cornered the local oil market and had prevented new supplies of oil from coming into the city, thus creating before the end of the year a monopoly price of 18 cents per gallon. In the new year the price soon fell back to a competitive level. Defendants asked a charge, which was refused, that if the jury should find that the fair market value of crude oil per gallon was 13½ cents on the 31st day of December, 1869, damages must be nominal. The trial court evidently felt that proof of the fact that oil was actually selling at a market price of 18 cents on the day in question, established its market value at that figure. In reversing, the upper court said:

Ordinarily, when an article of sale is in the market and has a market value there is no difference between its value and the market price and the law adopts the latter as the proper evidence of the value. This is not, however, because value and price are really convertible terms but only because they are ordinarily so in a fair market. . . .

It is equally obvious, when we consider its true nature, that as evidence, the market price of an article is only a means of arriving at compensation: it is not itself the value of the article but is the evidence of value. The law adopts it as a natural inference of fact, but not as a conclusive legal presumption. It stands as a criterion of value, because it is a common test of the ability to purchase the thing. But to assert that the price asked in the market for an article is the true and only test of value, is to abandon the proper object of damages, viz., compensation, in all those cases where the market evidently does not afford the true measure of value.

Becoming more specific as to its doctrine, the court continued:

. . . an inflated speculative market price, not the result of natural causes, but of artificial means to stimulate prices by unlawful combinations for the purposes of gain, cannot be a legitimate means of estimating just compensation. It gives to the purchaser more than he ought to have, and compels the seller to pay more than he ought to give, and it is therefore not a just criterion.

Applying these principles to the facts at bar, the court concluded:

It was, therefore, a fair question for the jury to determine whether the price which was demanded for oil on the last day of December, 1869, was not a fictitious, unnatural, inflated and temporary price, the result of a combination to "bull the market," as it is termed, and to compel sellers to pay a false and swollen price in order to fulfill their contracts. If so, then such price was not a fair test of the value of the oil, and the jury would be at liberty to determine from the prices before and after the day, and other sources of information, the actual market value of the oil on the 31st day of December, 1869. Any other cause would be unjust and injurious to fair dealers, and

would enable gamblers in the article to avail themselves of their own wrong and to wrest from honest dealers the fruits of their business.

In other words, the court sees that it would be unjust to permit a plaintiff who had wrongfully forced up prices to an artificially high level, to reap the advantages of his own wrong by using that price as the basis for measuring his right of recovery in a contract action.

The market price in *Kountz v. Kirkpatrick* had two special characteristics: first, it was unusual and temporary; second, it was created by the plaintiff seeking to rely thereon.[112] But the question arises whether either of these characteristics alone would lead to a rejection of actual selling prices. Most of the cases where only the latter element was present are typified by *Lovejoy v. Michels*.[113] This was a suit for the reasonable value of merchandise sold by the plaintiff to the defendant without any agreement as to price. Plaintiff claimed his usual selling price, which was a price agreed upon by an association of manufacturers of which plaintiff was a member. In other words, the market price here, as in *Kountz v. Kirkpatrick*, was a collusive one. But unlike the former case, the market price here was not shown to be temporary in duration or abnormal in amount. Nevertheless, the upper court rejected this price as the amount due from the defendant, stating:

> An attempt is made to fasten a price fixed by a combination upon such a purchaser. It is sufficient to know that the price sought to be imposed is that fixed by the combination. If so, it was unlawfully fixed, and has no force as a market price, for that reason. It is the combination for the purpose of controlling prices that is unlawful, and the fact that they, the manufacturers, deemed the prices fixed to be reasonable, does not purge it of its unlawful character.
>
> Independently of the unlawful character of the combination fixing it, a price so fixed cannot be regarded as any better evidence of value than that fixed by any vendor upon his own wares. A price so fixed is not to be entitled to rank as the market price. It is not a market price, within the contemplation of the law. The market price of an article manufactured by a number of different persons is a price fixed by buyer and seller in an open market, in the usual and ordinary course of lawful trade and competition. It cannot be divested of these incidents, and retain its character. Associations of this character give the buyer no voice, and close the market against competition.

112 The courts are chary of accepting as evidence of market value, sales made by the defendant of the very property in litigation, because there is a possibility that the sales might be fictitious. Groves v. Warren, 233 N.Y. 160, 135 N.E. 230 (1922); Latimer v. Burrows, 163 N.Y. 7, 57 N.E. 95 (1900); see Vance v. Meyers, 213 Ala. 660, 106 So. 142 (1925).

113 88 Mich. 15, 49 N.W. 901 (1891).

The amount that should be awarded does not appear from the opinion. In a similar case,[114] recovery was restricted to actual manufacturing cost with no allowance for profit.

Where the plaintiff is the sole manufacturer, or where the article is patented, there is no impropriety in his fixing the selling price, and the courts readily admit this price in evidence.[115] But even where the price is fixed by some combination, it should not be mechanically rejected where neither of the parties to the litigation had any hand in fixing it. This point was recognized in *Greenburg v. Whitney*,[116] where a customer sued his brokers for failure to deliver on demand shares of Stutz Motors held by him in a margin account. Shortly after plaintiff's purchase, at $122.25 per share, one Ryan cornered the market in Stutz Motors, the price rising fabulously. On March 31, 1920, the New York Stock Exchange suspended trading in the stock, and on April 14 the stock was stricken from the Exchange list. Thereafter it was traded in on the New York Curb, where it sold for $712.50 a share on April 20, the date when plaintiff demanded his stock from defendants. On April 24 Ryan and others involved in the corner agreed that members of the Stock Exchange who were short of Stutz Motors might settle on the basis of $550 per share. Defendants tendered $550 per share to plaintiff, who was not a participant in the corner. The court held that plaintiff was entitled to $712.50 per share.

The plaintiff demanded $712.50 per share, the price at which on April 20, when he demanded the stock, the shares were selling on the New York Curb, —the only place where the stock was then bought and sold. He was entitled to the market value, and as of that date. . . . The application of this general rule works hardship in the present case, because of the artificial enhancement of market value caused by the "corner" in Stutz stock. But apparently the stock was fully bought and sold on the curb at that time. If the plaintiff desired to repurchase, he could not do so at a lesser price, and presumably would go to the only market where the stock was then dealt in. He was in no way concerned with the scheme of raising the price. We cannot read into the law of damages an exception to meet a hard situation, when the plaintiff was free from blame, and the defendants failed to protect themselves.

[114] Wagoner Undertaking Co. v. Jones, 134 Mo. App. 101, 114 S.W. 1049 (1908).

[115] *Cf.* International Harvester Co. v. Chicago, M. & St. P. Ry., 186 Iowa 86, 172 N.W. 471 (1919); Baltimore & O.C.T. Ry. Co. v. Becker Milling Machine Co., 272 Fed. 933 (C.C.A. 7th, 1921).

[116] 245 Mass. 303, 139 N.E. 844 (1923). *Cf.* Fargo First National Bank v. Red River Valley National Bank, 9 N.D. 319, 83 N.W. 221 (1900); Ganson v. Tifft, 71 N.Y. 48 (1877).

But even in this type of case, the courts may reject evidence of the market prices if any special circumstance seems to justify such rejection. Where, for example, it was the custom on a produce exchange to buy more or less closely according to the quotations prepared by a committee of its members, based upon daily supply and demand and the like, the prices so fixed were held not even to deserve admission as *evidence* of value.[117] The proof showed that not all members of the exchange abided by such prices in their transactions; but the prices paid by the majority were surely as much evidence of value as the prices paid by the minority of the members.

We come now to the situation in which the market prices of the property, while not "manipulated," were "abnormal" because of the existence of a boom or a depression. This situation is illustrated by *Abrams v. Sinn,*[118] an action for damages for failure to convey land in the spring of 1919. It was there said:

> It may be, and doubtless is, true, as counsel for appellee says, that the spring and early summer of 1919 witnessed a sudden and extraordinary boom in Iowa land sales, and a remarkable temporary advance in the prices at which farm lands were held or sold. It was swift in its development, temporary in duration, and scarcely less swift in its decline. Now, while the worth or value of property is in one sense of the word what price it will command on the market, it is a reasonable and equitable proposition that, where damages are sought to be recovered for failure to convey land, its value is not conclusively established by reference to the peak prices or bottom prices of an abnormal, feverish, and fluctuating speculative market, but it is rather the fair value of the property as between one who wants to purchase and the one who wants to sell it—not what it could be obtained for in peculiar circumstances, when greater than its fair price could be obtained; "not its speculative value; not the value obtained through the necessities of another, nor, on the other hand, is it to be limited to that price which property would bring when forced off at auction under the hammer."

The difference in attitude between this case and the stock-brokerage cases is striking. In the latter cases, if the broker converts his client's securities or fails to make good a promised delivery he cannot successfully claim that their market prices exceeded their "true" or "fair" value. But, in the instant case, the fact that the current selling price represented a "boom value" led to a denial that this price should measure the damages.

[117] Brockman Commission Co. v. Aaron, 145 Mo. App. 307, 130 S.W. 116 (1910).

[118] 193 Iowa 528, 187 N.W. 491 (1922).

A contrary attitude appears in *Dady v. Condit,*[119] where the land which defendant failed to convey to plaintiff was in the suburbs of an industrial town which had been enjoying a land boom for several years. Although there was an eventual deflation due to the fact that only a part of the hoped-for development materialized, the court allowed recovery of high potential-factory-site prices for which, on performance day, the farm lands in the suburb had been selling. Perhaps the two cases can fairly be distinguished, both on the ground that the boom in the *Dady* case was of longer duration, and that it had more solid reason for its existence.

The most interesting opinion on the subject of abnormal market price is that in the *Proteus* case,[120] which we have already considered at length. This case suggests that the Supreme Court would have agreed with the decision in *Dady v. Condit* and that it *might* have disagreed with the decision in *Abrams v. Sinn.*

C. Measure of Damages for Mere Injury to Property.

The injury to a chattel held for sale presents a different situation from the injury to a chattel held for use. This is apparent from a consideration of the losses likely to be suffered. Where the sale price is diminished by less than the cost of repairing the damage, the owner who held it for sale would not be warranted in making the repairs. But the user is ordinarily interested only slightly in the sale price, either before or after the injury. Quite properly, therefore, he recovers the full cost of the repairs.[121] He may also be entitled to some allowance for any impairment in the sale value of the chattel even after it has been repaired.[122] Where the loss in sale value is greater than the cost of the

[119] 188 Ill. 234, 58 N.E. 900 (1900); (same), 209 Ill. 488, 70 N.E. 1088 (1904).

[120] 268 U.S. 146 (1925). *Cf.* U.S. v. New River Collieries Co., 262 U.S. 341 (1923), discussed *infra* p. 418, note 23.

[121] Cue v. Breeland, 78 Miss. 864, 29 So. 850 (1901); West v. Martin, 51 Wash. 85, 97 Pac. 1102 (1908).

[122] The courts are reluctant to recognize this. In Ryan v. Lewis, 3 Hun 429 at 431 (N.Y., 1875), the court says: "The measure of damages which the plaintiff was entitled to recover, if he recovered anything, was the amount the buggy was lessened in value by reason of the injury. The plaintiff could not cause repairs to be made upon it which did not make it as good as it was before the injury, and then recover in addition, the amount the repairs fell short of making it as valuable as before. There might be a controversy as to the manner in which the work was done, and as to the quality of the material used. If either was defective, the defendant would be obliged to pay more than the amount that would compensate plaintiff for the injury."

A similar view was taken in Patane v. State, 114 Misc. 713, 186 N.Y. Supp. 225 (1921). But in Schalscha v. Third Ave. Ry. Co., 19 Misc. 141, 43 N.Y. Supp.

repairs, the *user* may be limited to the cost of the repairs,[123] whereas the *dealer* should be entitled to recover the greater sum.

An exception to the foregoing rule suggests itself. The plaintiff-user may be a wealthy man who would not use a repaired article; for example, a dent in the hood of his automobile might lead him to purchase a new hood, although the damage could be repaired so as to be hardly noticeable. In the absence of reported opinions on this issue, we surmise that the courts would permit the recovery of the cost of the new hood where the substitution was actually made, and if found by the jury to have been *reasonably* made.

Although the foregoing discussion is in terms of chattels, the identical problems arise in connection with realty. Speaking generally, the realty cases are decided in the same way as are the cases dealing with personal property,[124] except for the complicating factor introduced by the preliminary question whether the wrong should be considered as an injury to real property or a destruction of personal property. The latter subject has already been considered.[125]

VI. Conclusions.

A critique of the rulings of the courts on the measure of damages is beyond the scope of this treatise, since they raise many questions other than that of estimating value. Our discussion is intended to disclose the fact that, even within the single legal field of damages, the "value" of the property may mean one thing in one case, and a substantially different thing in another case. This is true not only where the value is said to be measured by some standard other than market value, such as intrinsic value, or value to the owner, but also where market value is itself the verbal standard. The apparent uniformity as to the measure of damages is therefore a specious one.

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251 (1897), where an injured violin was repaired, in as satisfactory a manner as possible, the cost of the repairs and diminution in value despite the repairs were both awarded. Howe v. Johnston, 220 App. Div. 170, 221 N.Y. Supp. 516 (1927), appears to declare, as the New York law, that the measures are alternative.

[123] Where a wagon was injured in a collision with an automobile and it appeared that the cost of putting the wagon in as good condition as before the injury amounted to $27, it was held that testimony that the wagon had shrunk in value by reason of the injury from $200 to $50 was purely fanciful and could not be made the basis of a jury verdict. Mendleson v. Van Rensselaer, 118 App. Div. 516, 103 N.Y. Supp. 578 (1907). See also Moore v. Metropolitan Street Ry. Co., 84 App. Div. 613, 82 N.Y. Supp. 778 (1903).

[124] Sedgwick, *Damages*, Vol. III, Chap. 41.

[125] *Supra* pp. 334–335.

It is a commonplace among current economists, and it is coming to be more and more clearly recognized by judges, that the interpretation that should be placed on the phrase "value of the property" depends largely on the purpose for which the valuation is to be made. In the field of damages, this point has been recognized in the many judicial statements that the "value" awarded should constitute "a just indemnity" for the wrong done to the plaintiff. But the courts, despite their repeated lip service to this principle, decline to follow it with logical rigor, since they usually reject the one concept of value, value to the owner, which comports with the principle. In the previous chapter we expressed our opinion as to the reasons for this discrepancy.

If the standards of value which the courts have adopted in lieu of value to the owner were themselves definite standards, the mere fact that they create a wide rift between the measure of damages and the amount of loss suffered by the plaintiff would be a matter of no concern to the expert in valuation. But since they are obviously not definite, we may raise the question whether the law of damages would not have been more satisfactory in practice, and more comprehensible in theory, if it had proceeded logically from the principle of full compensation, without invoking the intermediate principle of awarding the "value of the property." Modifications of, and departures from, this principle could then be stated in terms either of specific or of general exceptions, some of which would be designed to exclude speculative and confusing evidence as to the amount of the actual loss, and others of which would take the form of frank derogations from the principle of indemnity, such as the rule in *Hadley v. Baxendale*. Under this substitute scheme, the choice between alternative concepts or measures of "value," if value is to be considered at all, would depend merely on the question of securing the closest possible approximation to indemnity.

That the above suggestion has some merit, whatever may be the chance of its adoption in this country, is evident from the fact that the leading Continental legal systems, such as the French[126] and the German,[127] employ similar master principles, with more or less elaborated exceptions, and that as prominent a student of the Anglo-American law of damages as Sedgwick[128] has deemed them worthy of study by the common-law lawyer.

So far as the present law of damages is concerned, with its constant reliance on "value of the property," we suggest the special need of

[126] French Civil Code, §§1149–1151.
[127] German Civil Code, §§249–255.
[128] Sedgwick, *Damages*, Vol. I, p. 22.

revising the phrases by which the courts instruct juries as to the measurement of damages in those cases where the property cannot be valued, for the purposes of the award, by reference to current price quotations in an active market. Here the courts have either resorted to meaningless terms, such as "actual value" or "intrinsic value," or else they have invoked the notion of a hypothetical market value as between a fictitious willing buyer and an equally fictitious willing seller.[129] In such cases, the complete abandonment of any reference to value, and the direct attempt to measure the owner's loss, would seem to be called for. But in so far as "value of the property" is used as the verbal measure of recovery in *any* damage suit, the definition of value should be guided, not by the question, What is *the* true meaning of value? but rather by the question, What meaning should here be given to this indefinite word in view of the function that it is designed to perform in the particular case at bar?

[129] Our objection to this fiction is, not that it is a *fiction*, but that it is indefinite and ambiguous. See *supra* pp. 59–61.

CHAPTER XV

THE MEASUREMENT OF FIRE-INSURANCE LOSSES*

Closely related to valuation under the law of damages is the appraisal of property as the measure of a loss recoverable under an insurance policy. A complete treatment of this subject would require consideration of many types of insurance, differing materially in the applicable rules of valuation.[1] But we have restricted our study to

* This chapter is substantially a complete reprint of our earlier article, "Valuation of Property to Measure Fire Insurance Losses," by James C. Bonbright and David Katz, 29 *Col. L. Rev.* 557 (1929). More recent cases have not been canvassed.

[1] From the valuation aspect, perhaps the most interesting of the omitted fields of property insurance is that of marine insurance, which is governed by quite different rules from those applied to the standard fire-insurance policy. Most marine-insurance policies are valued policies, which seldom raise any problems of valuation except in case of partial rather than total loss. Non-valued policies are also issued, however. Where the policies state the measure of recovery in general terms, such as "cash value," the American courts have interpreted this to mean the value at the time when, and place where, the risk commenced—that is, where the policy took effect—, not the value either at the point of destruction or at the point of destination. This rule has been applied both to the evaluation of ships, Marshall, *Marine Insurance* (5th ed., 1865), p. 503, and of cargo, Warren v. Franklin Ins. Co., 104 Mass. 518 (1870). In valuing the ship, courts have accepted a standard which they call "sound value," by which they seem to have meant the market value of the ship where it does have a fair market value or cost of reproduction minus depreciation in the absence of a fair market.

In the valuation of the cargo some courts have accepted as the basis the so-called prime cost, that is, the cost incurred by the shipper, including cost of insurance and freight to the point of shipment. Other courts, however, have taken the market value of the goods at the time and place of shipment instead of the prime cost. Le Roy v. Unit Ins. Co., 7 Johns. 343 (Sup. Ct. N.Y., 1811); Carson v. Marine Ins. Co., 5 Fed. Cas. 178 (C.C.D. Pa., 1811).

Some interesting questions arise in connection with the insurance of liability for what is called the "general average loss." This refers to the apportionment of liability for loss of cargo which has been jettisoned and for expenses incurred in order to save the cargo and the ship. In this situation there is a rule of law to the effect that the loss must be apportioned to the owners of the jettisoned cargo, of the remaining cargo, and of the ship on the basis of the relative values of these three things. For the purpose of determining these relative values, however, different rules as to the time and place of valuation are adopted from those noted above as applying to the measurement of recovery for total loss. The subject is

fire insurance, which has given rise to the most important case law on appraisal. Even with respect to this type of insurance, our discussion is limited to the measurement of a "total loss" as distinct from a mere injury or partial destruction.[2]

Because the objective of insurance is indemnification, one might expect that the courts would here adopt the same general concepts of value that they have applied under the law of damages. This expecta-

too complex, however, for discussion in this note. In general, marine-insurance law shows a much greater tendency than does fire-insurance law to crystallize the rules of recovery where the policy makes the basis of recovery depend on the cash value of the property. That is to say, there is less effort to make the time and place of valuation depend upon an attempt to grant indemnity under the particular circumstances of the case, and there is much greater adherence to easily administered rules of thumb. Winter, *Marine Insurance* (2d ed., 1929), Chap. 18.

[2] The omission of a discussion of the measurement of partial loss would seem at first to be serious in view of the fact that most insurance losses are of this type. However, the reported opinions on this subject raise but few interesting valuation problems. This is due largely to the fact that in most cases the amount of loss is measured by the estimated cost of repairing the property, a measure which does not require a valuation. It may be worth while, however, to summarize briefly the general principles applied to the measurement of partial losses.

1. Partial Losses under a Non-valued Policy.

(*a*) *Personal Property.* The stated measure of recovery here is the difference between the value of the property before and after the injury. Farmers Merc. Co. v. Ins. Co., 161 Iowa 5, 141 N.W. 447 (1913). In ascertaining the value of the property in its uninjured condition courts follow the usual rules applied to cases of complete destruction. Hoffman v. Aetna Ins. Co., 1 Rob. 501 (N.Y. Super. Ct., 1863), *aff'd,* 32 N.Y. 405 (1865). The measurement of the value of the property *after* the injury has been discussed in only very few cases. In Farmers Merc. Co. v. Ins. Co., *supra,* the court stated that the proper method was to secure the testimony of witnesses as to the value after the fire, although it indicated that there was no error in permitting a witness to state the value before the fire and then to state the percentage of depreciation resulting from the injury. Two cases hold that, where the insured disposes of the damaged property at public auction, the amount received therefor is proper, though not necessarily conclusive, evidence of the value after the fire. Reading Ins. Co. v. Egelhoff, 115 Fed. 393 (C.C.W.D. Mo., 1902); Clement v. British Ass. Co., 141 Mass. 298, 5 N.E. 847 (1886).

(*b*) *Real Property.* There are three possible measurements of partial loss in these cases:

(1) Cost of restoring with materials of like kind and quality.

(2) Difference between the value of the building before and after the fire.

(3) Difference between the value of the entire piece of real estate (that is, building plus land) before and after the fire.

Unfortunately the reported cases are not clear either as to which of these methods is being used or as to the methods of valuation to be applied to the second and third. This paucity of discussion is probably due to the limiting clause in the standard policies, which prevents recovery in excess of the cost of repairing or

tion, indeed, is borne out by the cases.[3] Yet we must note certain important differences between these two related fields of law, which may lead to distinctions in the theory and technique of appraisal.

Among these differences is, first, the fact that the measure of insurance losses, unlike the ordinary measure of damages, is set by contract—that is, by the terms of the policy. This policy contains clauses defining "value" and setting other limits to the recovery, such as the limiting clause restricting recovery to no more than replacement cost. Another distinction arises from the fact that the psychological setting, which may lead to a higher or a lower appraisal, may differ markedly as between the two related fields of litigation. In a damage suit, on the one hand, there is likely to be present the element of guilt, or at least of negligence, in the act of the defendant, which is not present with respect to the company in the insurance case. On the other hand, in the measurement of insurance loss there may be present in the mind of the judge, if not of the jury, the desire to guard against the so-called "moral hazard"—that is, the risk of incendiarism that undue liberality would encourage. Offsetting this tendency

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replacing. Commercial Fire Insurance Company v. Allen, 80 Ala. 571, 1 So. 202 (1886).

2. Partial Losses under Valued Policies.

In most jurisdictions it has been held that the recovery for partial loss is to be measured under valued policies in just the same way as under non-valued policies. Richards, *Insurance* (3d ed., 1909), p. 300. In some jurisdictions, however, the amount stated in the policy is conclusive of the value before the fire, and the measure of loss is this face value less the value of the property after the fire. Bice v. Home Ins. Co., 1 Har. 294, 114 Atl. 211 (Del., 1921).

From the point of view of the theory of valuation, the most interesting question involved in the measurement of partial loss is the question whether the estimate of a loss as measured by the difference between value before and after the injury can result in a different figure from the estimate of loss as measured by the cost of repairing the damage. For example, can a building which has been damaged by fire and which would cost $10,000 to restore to its previous condition be said to have depreciated in value by an amount in excess of $10,000? The presence of the limiting clause in the fire-insurance policies, however, has prevented this question from being raised in cases of this type. The same point has been at issue, however, in damage cases. Fitzsimons & Connell Co. v. Braun, 199 Ill. 390, 65 N.E. 249 (1902); Dammann v. City of St. Louis, 152 Mo. 186, 53 S.W. 932 (1899); Bates v. Warrick, 77 N.J. L. 387, 71 Atl. 1116 (1909); City of Globe v. Rabogliatti, 24 Ariz. 392, 210 Pac. 685 (1922). See also Chap. XIV, subsection on "Buildings."

[3] See McAnarney v. Newark Fire Insurance Co., 247 N.Y. 176 at 181, 159 N.E. 902 at 903 (1928): "Actual cash value equals actual value expressed in terms of money. For methods by which actual value may be ascertained we must look beyond the terms of the policy to the general principles of the law of damages."

toward a low valuation, however, is the likelihood that the insurer may be thought of, by the jury at least, as a rich defendant which can afford to bear a heavy payment. There is the further possibility that a jury may be influenced by the fact that the insured has *paid* for a certain amount of insurance—an amount which has already been approved by the insurer—with the resulting tendency to make the recovery approximate the total amount insured for in case of a complete destruction of the property.[4]

Just how these subtle psychological influences may work themselves out in the actual awards is a question that our study of judicial opinions is unable to answer. An answer could be given, if at all, only by persons who are intimately familiar with the responses of juries and judges to the special fact situations of insurance cases. The most that can be attempted here is to note how these fact situations may have affected the principles as enunciated by the courts in their written opinions.

The Nature of the Policy as Affecting the Measure of Recovery.

Before discussing the litigated cases, we must note the precise nature of the contract, as stated in the policies, on the interpretation of which the decision may turn.

Policies insuring against loss of property are either "valued" or "non-valued." A "valued policy" is one in which, for the purpose of the risk insured, the value of the property is agreed upon by the parties and is expressed on the face of the policy.[5] A policy which merely states that the amount of insurance is for a fixed sum, or one which merely estimates the value of the property, is not a "valued policy."[6] In the absence of legislation, valued policies are most frequently used in marine insurance. In the event of a total loss, the insured is entitled to the agreed value and need not adduce any evidence as to the actual value of the property destroyed.[7] The agreed value may be disre-

[4] Undoubtedly the majority rule, that the face value of the policy is not admissible as proof of the value of the property destroyed, is an attempt on the part of courts to forestall any such result. German Ins. Co. v. Everett, 36 S.W. 125 (Tex. Civ. App., 1896); Home Ins. Co. v. Stone River Nat'l Bank, 88 Tenn. 369, 12 S.W.915 (1889); Lion Fire Ins. Co. v. Starr, 71 Tex. 733, 12 S.W. 45 (1888).

[5] Cooley, *Briefs on Insurance* (2d ed., 1928), Vol. VI, p. 4889; Clement, *Fire Insurance* (1905) Vol. I, p. 93; Richards, *Insurance, supra* note 2 at p. 21; May, *Insurance* (3d ed., 1891) Vol. I, p. 47; *The Standard Fire Insurance Contract* (1922), p. 278; Mont. Rev. Codes (Choate, 1921) §8116; S. D. Rev. Code (1919) §1418.

[6] Williams v. Continental Ins. Co., 24 Fed. 767 (D. Minn. 1885); Lycoming Ins. Co. v. Mitchell, 48 Pa. 367 (1864); Cooley, *op. cit.*, Vol. VI, p. 5098.

[7] Cooley, *op. cit.*; see Williams v. Continental Ins. Co., *supra* note 6.

garded, however, if the insurer can show that it was arrived at as a result of misrepresentation by the insured.[8]

In some states, "valued-policy" laws have been enacted. Some of these statutes provide that policies covering real property (or, in a few states, any type of property) against loss by fire or other expressed risks shall contain an agreement as to the value of the property and that this stipulated value shall be conclusive.[9] Other statutes provide that a policy shall be considered a liquidated demand against the company for the full amount stated in the policy.[10] This latter type of statute differs from the former in that it seems to obviate the necessity of incorporating in the policy an explicit agreement as to value. A third type of statute merely makes the face amount of the policy prima-facie evidence of the value.[11] Under the first two types of statutes the insurer may not upset the fixed value, except where he can show that the valuation was procured by fraud.[12]

In most jurisdictions the use of valued policies is forbidden by the enactment of laws requiring the use of the "non-valued" or "open" policy.[13] This type of policy, which is the one with which we are concerned in the present chapter, leaves the measure of loss to be determined after the catastrophe has occurred.[14] The amount for which the property is insured is, therefore, simply the upper limit of recovery. As to the measure of loss under open policies, some simple types of contract consist merely of a promise on the part of the insurer to

[8] Cooley, *op. cit.*, *supra* note 5, Vol. VI, p. 5098.

[9] Del. Rev. Code (1915) §599; Fla. Gen. Laws (Skillman, 1927) §6240; Ky. Stat. (Carroll, 1922) §700.

[10] Ark. Dig. Stat. (Crawford and Moses, 1921) §6147; N.H. Laws 1885, C. 9352.

[11] Iowa Code (1927) §976.

[12] Hartford Fire Ins. Co. v. Redding, 47 Fla. 228, 37 So. 62 (1903); Fadden v. Insurance Co., 77 N.H. 392, 92 Atl. 335 (1914).

[13] In some jurisdictions the "non-valued" policy must be used in writing insurance on personalty; the "valued" policy is required as to realty. Thus in Nebraska, the valued-policy law, Comp. Stat. (1922) §7809, is not affected by Comp. Stat. (1922) §7836, relating to the "non-valued" policy. See Cooley, *op. cit.*, *supra* note 5, Vol. VI, p. 5101.

[14] Both the valued and the non-valued policies have their own obvious advantages and disadvantages. The former avoids most litigation and permits the amount of the premium to be adjusted to the amount of loss for which the insurer is really liable. The latter, on the other hand, avoids the necessity of expensive appraisal of all property prior to the placing of the insurance. It also aims to restrict recovery to the loss actually suffered at the time of the fire, which may be far less than the value of the property at the time of the writing of the policy. The chief reason for using the valued policy in marine insurance is that the values of a ship and cargo at the time of the loss are extremely difficult to estimate with confidence.

"indemnify" or to "save the insured harmless" in the event of loss.[15] Others make "cash value" or "actual cash value" of the property destroyed the basis of recovery,[16] and of these a few add various instructions as to the methods of ascertaining the value in question.[17]

At the present time the forms of the policies are prescribed by statute in practically every state, and it is obligatory upon a company writing insurance in any one state to use the standard form. The use of standard policies began in Massachusetts in 1882.[18] The policy there prescribed reads that the company "shall not be liable beyond the actual value at the time any loss or damage happens." New York, in 1886, established a standard policy providing that

> . . . the company shall not be liable beyond the actual cash value of the property at the time any loss or damage occurs, and the loss or damage shall be ascertained or estimated according to the actual cash value with proper deductions for depreciation, however caused, and shall in no event exceed what it would then cost the insured to repair or replace with material of like kind and quality.[19]

In 1918 the present New York standard superseded the older policy.[20] It provides that the company

> . . . does insure to the extent of the actual cash value (ascertained with proper deductions for depreciation) of the property at the time of the loss or

[15] In Carey v. London Provincial Fire Ins. Co., 33 Hun 315 (Sup. Ct. N.Y. 1884), the policy was so written.

[16] Home Ins. Co. v. Stone River Nat'l Bank, *supra* note 4, at 377: "The undertaking of the company as expressed in the policy was 'to make good . . . all such immediate loss . . . to be estimated according to the actual cash value of the property at the time of the loss.' . . . "

[17] An illustration of this type of policy is found in Ins. Co. v. Lumber Co., 186 N.C. 269 at 271, 119 S.E. 362 at 363 (1923). After making actual cash value the basis of recovery, the policy read: "the cash value of the leaf tobacco covered by this policy shall be computed at not more than the average price obtained on sales of leaf tobacco in public sales warehouses nearest to the agency issuing this policy, said sales to embrace a period of one week prior to the date of the fire as per authentic official records of such warehouses; said average price to be found by dividing the total quantity sold during the period specified into the total price obtained during such period."

[18] An attempt to draw a standard policy was made in 1873 (Mass. Laws 1873, C. 331). Its use was not compulsory. The present policy was enacted in 1882 and now is part of the General Laws of Massachusetts (1921), C. 175, §99.

[19] N. Y. Laws 1886, C. 448; Gen. Laws of 1892, C. 38; *The Fire Insurance Contract* (1922), pp. 20 *et seq.*

[20] Birdseye, Cumming and Gilbert, *Consolidated Laws of New York* (2d ed., 1917), Vol. IV §121.

the damage, but not exceeding the amount it would cost to repair or replace the same with material of like kind and quality, within a reasonable time after such loss or damage.

The Massachusetts, the old New York, and the present New York standard policies are the models of policies required or used throughout the country,[21] save in those jurisdictions which require the use of "valued policies."

It will be noted that, while the Massachusetts form makes "actual value" of the property the measure of recovery, both of the New York forms in effect set the measure at the lesser of two amounts—(*a*) cash value or (*b*) replacement cost. The question therefore arises as to what, if any, effect the limiting clause in the New York forms may have on the amount of the recovery. Conceivably the effect may be nil because of the judicial practice of interpreting "cash value" itself either as synonymous with or limited by replacement cost. It is necessary, therefore, to discuss first the meaning of "cash value," and afterwards to consider the real significance of the replacement-cost clause as a limiting feature.

Cash Value as a Device for Fixing the Amount of Damage.

It is a cardinal doctrine in the law of property insurance, no less than in most divisions of the modern law of damages, that the measurement of the recovery must be governed by the principle of indemnity.[22] By this is meant that the amount for which the insurer is liable

[21] The Massachusetts type of policy is used in Me., Rev. Stat. (1916) §848; Minn., Gen. Stat. (1923) §3512; and N.H., Pub. Laws (1926), C. 276, §1. The old New York standard is still law in Cal., Gen. Laws (Deering, 1923), Art. 3729, §18½, C. 192; Conn., Gen. Stat. (1918) §4075; La., Const. and Stat. (Wolf, 1920) §22; Okla., Comp. Laws (1921) §6767; R. I., Gen. Laws (1923) §3813; S. D., Rev. Code (1919) §9199 (S. D. at first had the Mass. type of statute, S. D. Laws 1907, C. 170); and Iowa, Code (1924) §9018 (in the Iowa policy the word "then" is omitted). The following states have enacted the present form of the New York standard: Ariz., Rev. Stat. (1913) §3440; N. J., Comp. Stat. (1910) §77, p. 2862, Cum. Suppl. (1924) 1586; Neb., Comp. Stat. (1922) §7836; N.C., Cons. Stat. Ann. (1919) §6437; Mich., Comp. Laws (Cahill Supp. 1922) 1056; Pa., Purdons Digest (Supp. 1916–1921) 8552; W. Va., Code Ann. (Barnes, 1923) 622; Wis., Stat. (1925) 1608. Other jurisdictions provide that the insurance commissioner shall draw up a policy to be used within the state: Ga., Ann. Code (Park, 1908) §2470; N.D., Comp. Laws Ann. (1913) §6625; Ore., Laws (Olson, 1920) §6393.

[22] Much discussion can be found in the legal opinions as to whether or not different forms of insurance policies are to be deemed "contracts of indemnity." There is some confusion here because of the fact that the phrase "contract of indemnity" is used in two different senses. In its narrower sense, it may denote a contract under which there may be no recovery in excess of an amount sufficient

shall not exceed full compensation to the insured for the injury sustained. The allowance of a greater sum is regarded as an evil, first because it turns the insurance policy into a gambling contract, and second because it creates a "moral hazard," due to the temptation of the insured to cause the very loss which is being covered, or, at all events, to provide no adequate safeguards against the loss.

Reasoning from this doctrine of indemnity as a premise, one might infer that the "values" which courts will accept in the insurance cases are simply a measure of the injury done to the owner through being deprived of his property. "Value" would then mean "value to the owner," which in turn would be simply an expression in positive form of the damage done to the owner because of the deprivation. As a matter of fact, the construction placed by courts on the meaning of "cash value" has been greatly influenced by this line of reasoning. But the courts have not carried the close association between the "value" of property and the injury resulting from its destruction to the point of completely identifying the two concepts. On the contrary, they have often applied principles of valuation which must result sometimes in more and sometimes in less than full compensation.

This discrepancy between the "cash value" of the property and the amount of injury which its destruction causes the owner, is to be explained by the fact that courts have tended to think of *value* as something more or less intrinsic and objective, with the result that their valuations have often deliberately disregarded certain peculiar circumstances which bear on the significance of the particular property to the particular owner at the precise time when the destruction took place. More specifically, there has been a tendency to identify cash value with replacement cost even in those cases where this standard obviously departs widely from a measure of the injury sustained by the owner of the property.

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to indemnify the insured for all loss sustained by him. In a broader sense, however, the term may refer to any contract the *purpose* of which is to indemnify the insured (as distinct from the contrary purpose implied in the wagering contract). According to this broader definition, a valued policy would be regarded as a "contract of indemnity" even though the amount of recovery allowed in any individual case happened to exceed what would be regarded as complete indemnity, so long as the purpose of the contracting parties may be presumed to have been to provide only for indemnity. According to the narrower definition, however, only a non-valued policy could be regarded as strictly a contract of indemnity. See Eagle Ins. Co. v. Lafayette Ins. Co., 9 Ind. 443 at 445 (1857); Getchell v. Merc. Mfg. Co., 109 Me. 274 at 277, 83 Atl. 801 (1912); Tabbut v. Am. Ins. Co., 185 Mass., 419 at 421, 70 N.E. 430 at 431 (1904); Richards, *Insurance* (3d ed., 1909), p. 27.

Some courts have even held that the identification of value with replacement cost is quite in conformity with the principle of indemnity; for they have taken "indemnity" to mean, not an amount sufficient to put the owner in as good a position as he was before the fire, but rather an amount sufficient to enable him to replace the destroyed property with substantially similar property.[23] "Indemnity" is thus confused with "restitution." As will be noted in the review of the cases, however, there has been a distinct tendency on the part of the courts, within recent years, to adhere more closely to the principle of indemnity and to depart more freely from the principle of physical restitution. This tendency has taken the form of a disposition to require full deductions for depreciation *of all kinds* before replacement cost will be accepted as a measure of cash value. It has also manifested itself in an increased readiness, at least of some courts, to abandon completely the use of replacement cost as the measure of cash value in certain cases where the fact situation indicates that another measure of recovery would come closer to a compensation for the loss actually sustained.

But the growing tendency of courts to make the basis of valuation accord more and more closely with the principle of indemnity is subject to much greater qualification in cases where the application of cost of physical restitution would result in *under*indemnity than in cases where it would result in an excess compensation. This is true because standard fire-insurance policies, even when designed to limit recovery to no more than an indemnity for loss, do not purport even in theory to compensate for the *entire* loss that may result from the destruction of property. A distinction is drawn between those losses that are reflected in the cash value of the property destroyed, and those additional, incidental losses that the owner may suffer because of sudden deprivation.[24] Examples of the losses of the latter type would be the loss of profit resulting to a factory owner because of a temporary shutdown following a fire, losses of rent or of the use of a new building between the time of its destruction and the erection of a new building, losses of the opportunity of selling his goods at a profit because of the fact that these goods cannot be replaced in time to avoid missing the market, and liabilities for breach of contract that a vendor may incur because the destruction of his goods forces him to default in his delivery. All of these damages clearly would be covered by any policy that

[23] Washington Mills Emery Mfg. Co. v. Ins. Co., 135 Mass. 503 (1883); Merchants Ins. Co. v. Frick, 5 Ohio Dec. 47 (1873).

[24] Baroness of Pontalba v. Phoenix Assurance Co. of London, 2 Rob. 131 (La. 1842); Farmers Mut. Ins. Co. v. New Holland Turnpike, 122 Pa. 37 (1888).

provides for complete indemnity; yet, with some exceptions that will be noted later, they are all held to be excluded under the standard fire-insurance policy. The exclusion is based partly on the operation of the limiting clause in these policies, which limits recovery to replacement cost, and partly on the interpretation of the meaning of cash value itself, which is generally construed to exclude an allowance for loss of profits, rents, etc. These incidental losses may be covered only by special forms of insurance, such as "use-and-occupancy," "rent," or "profits" insurance.[25]

The distinction thus drawn between that part of a loss which is reflected by the value of the destroyed property (which is alone covered by the standard policy) and that other part of the loss which is thought of as "incidental" (which must be covered by more specialized types of policy) is a distinction familiar to the student of damage law. In this related field of law, liability for "general damages" is limited to "the value" of the property, while liability for "special damages" applies to those cases where a plaintiff is allowed also to recover for additional loss. But the insistence of the courts that there is a distinction between what property is "worth" and what harm is done to the owner who is deprived of it, raises a nice problem in the theory of valuation. The problem is whether any such distinction does not involve a self-contradiction in terms. Is not the *value* of any form of wealth simply a monetary expression of the significance of that wealth to its owner? And is not this significance necessarily to be measured by the injury that would be suffered by the owner as a result of its loss or destruction? One possible reply to these questions suggests itself. The term "value" may conceivably be taken to mean, not the value of the

[25] To protect himself fully from losses of different varieties that might result from the destruction of his physical property, the insured must avail himself of diverse types of insurance. For example, a merchant, in addition to taking out a policy on the value of his stock, must insure against loss of the profits that he would make in due course of business but for the fire. Page v. Northern Ins. Co., 141 App. Div. 239, 125 N.Y. Supp. 1066 (1st Dept., 1910). The owner of a building must get coverage for loss of rents for the period of rebuilding or repairing his building. Syndicate Co. v. Ins. Co., 85 Kan. 367, 116 Pac. 620 (1911); O'Brien v. North River Ins. Co., 212 Fed. 102 (C.C.A. 4th, 1914). A manufacturer who desires complete protection must provide against: (*a*) loss of building and machinery; (*b*) loss of profits that would be derived by continued use of building; (*c*) loss of fixed charges during disuse of building; (*d*) loss of the product on hand at time of fire; (*e*) loss of profit that would have been earned by sale of said product.

The situation here is similar to that in the field of marine insurance, where it is customary to insure separately (*a*) the ship; (*b*) the freight to be earned on the voyage; (*c*) the value of the cargo at point of departure; (*d*) the profit to be made on cargo in the distant market, etc.

property to its particular owner but rather its *market value*, that is, what it would sell for. In that case, the statement that the loss of property may cause its owner a far greater injury than is represented by its value would not be a self-contradictory statement. Unfortunately, however, this possible escape from the verbal difficulty is cut off by the courts themselves, which reject market value (in the sense of price for which the property could be sold) as the proper criterion in the valuation of many types of property. As a rule courts are far more generally disposed to accept replacement cost even when it departs from probable selling price.

The correct answer to this theoretical question seems to be that the distinction drawn by the courts between "value" on the one hand and "complete indemnity" on the other hand is largely arbitrary. Instead of being in reality a distinction between value and full loss, it is typically a distinction between full loss on the one hand, and such part of that full loss as is represented by replacement cost (minus certain deductions for depreciation) on the other hand. No doubt there are excellent practical reasons for drawing a line of this nature between losses that are covered by standard fire insurance and other losses that may be covered only by special forms of insurance. What seems unfortunate to a student of valuation, however, is that the fictitious nature of the distinction between cash value and incidental loss has seldom if ever been recognized by the courts. From a practical viewpoint it is even more unfortunate that courts have not been in agreement as to where to draw the line, and that some of them have included, while others have excluded, certain losses of profits in computing the cash value itself.

Cash Value as Interpreted by the Reported Cases.

Just as in damage cases, so in insurance cases, courts frequently attempt to define value by such phrases as "market value," "real value," or "value to the owner."[26] These ambiguous and indefinite phrases, although they are given great prominence by the textbook writers,[27] as if they really stated the rules of valuation, are worse than

[26] "The cash value of a thing is its fair market value." Farmers Merc. Co. v. Ins. Co., 161 Iowa 5 at 21, 141 N.W. 447 at 454 (1913). "The expression 'market value' of an article and its 'actual cash value' have practically the same meaning." Manchester Fire Ins. Co. v. Simmons, 12 Tex. Civ. App. 607, 35 S.W. 722 at 723 (1896). "Cash value" is not market value, under the facts but real value or value to the owner. Johnston v. Farmers' Fire Ins. Co., 106 Mich. 96 at 99, 64 N.W. 5 at 6 (1895).

[27] Richards, *Insurance* (3d. ed., 1909), pp. 296 *et seq.;* Clement, *Fire Insurance* (1905), Vol. I, pp. 91 *et seq.;* May, *Insurance* (4th ed., 1900), Vol. II, §423 *et seq.;* Cooley, *Briefs on Insurance* (2d ed., 1928), Vol. VI, pp. 5084 *et seq.*

useless in arriving at sound conclusions as to what principles of valuation the courts are actually applying. Whatever generalizations it is possible to make can be secured only by a study of the types of evidence that judges admit and stress, as well as by an examination of the instructions to the jury that are discussed by appellate courts in the published opinions. Because of the different fact situations in different types of cases, it has been thought wise to divide the discussion into four sections which consider separately the valuation of (*a*) merchandise in the hands of a dealer, (*b*) manufactured goods in the hands of the manufacturer, (*c*) personal property held for use, and (*d*) buildings for residential and commercial purposes.

A. Merchandise in the Hands of a Dealer.

With respect to the cases mentioned both in this and in the following section, the peculiar problem of valuation lies in the fact that, since the goods are designed for sale, their selling price might conceivably be taken as a measure of their value even though selling price might be rejected as the test where the property is in the hands of a consumer. In the large majority of cases of this type, the main issue has been between a valuation based on mere replacement cost, which is contended for by the insurance company, and a valuation based on current selling prices (including a markup for profits), which is contended for by the insured.

With respect to goods in the hands of dealers, as distinct from goods in the hands of manufacturers, the holdings are almost unanimous to the effect that cash value means replacement cost rather than selling price.[28] It is true that the rule of recovery in cases of this kind is generally stated as the "current market value" at the time of the fire. Market value, however, has been interpreted to refer to the market in which the dealer *purchases* the goods rather than the market in which he *sells* the goods. Consequently, if goods are destroyed in the hands of a wholesaler, the measure of recovery is the current selling price as quoted by manufacturers; whereas if the identical goods are destroyed in the hands of a retailer, the recovery is based on current wholesale price. In justification of this position the courts have repeatedly stressed the point that the recovery should be limited to indemnity

[28] Texas Moline Plow Co. v. Niagara Ins. Co., 39 Tex. Civ. App. 168, 87 S.W. 192 (1905); Niagara Fire Ins. Co. v. Heflin, 22 Ky. Law Rep. 1212, 60 S.W. 393 (1901); Fisher v. Crescent Ins. Co., 33 Fed. 544 (C.C.W.D.N.C., 1887); Mutual Fire Ins. Co. v. Owen, 148 Md. 257, 129 Atl. 214 (1925); Boise Assn. of Credit Men v. U.S. Fire Ins. Co., 44 Idaho 249, 256 Pac. 523 (1927); Grubbs v. N.C. Home Ins. Co., 108 N.C. 472, 13 S.E. 236 (1891); *cf.* Mack v. Lancashire Ins. Co., 4 Fed. 59 (C. C. D. Mo., 1880).

only and should, therefore, not include the unrealized profit that would be included in the selling price of the goods.[29]

Obviously, however, the allowance to a dealer of mere replacement cost would under certain circumstances fall short of a complete indemnity.[30] This is notably true where the dealer is able to replace the lost articles only after the lapse of so long a time that he misses his market. It would also be true where the dealer's place of business has been destroyed along with his stock of goods. The question arises, therefore, whether a court would permit a recovery in excess of replacement cost, measured either by full selling price or by some mid-price such as net selling price, when the insured can prove that he has lost an opportunity to make a profit. Unfortunately, no case directly in point has been found. An analogous situation, however, has arisen with respect to goods destroyed in the hands of manufacturers, and here it seems that courts have sometimes made the rule of recovery depend on whether the manufacturer was probably in a position to replace his goods by remanufacture in a sufficiently short time to avoid missing his market.[31] A similar decision might possibly be rendered in the case of goods in the hands of dealers,[32] where the

[29] Niagara Fire Ins. Co. v. Heflin, *supra* note 28. The trial court had estimated the plaintiff's damages by adding to the value of the goods a 20 per cent markup for profits that would have been realized by sale but for the fire. It was held on appeal that such expected profits were not recoverable.

[30] It is unfortunate that some courts, not only in fire insurance but also in the related field of damages, have expressed and apparently acted upon the assumption that indemnity necessarily excludes any compensation to the injured party for profits. As a matter of fact, what the concept of indemnity properly excludes is simply a profit or gain resulting from the fire itself. It contemplates an allowance for profits that would have been made if the fire had not occurred but which cannot be made as a result of the fire.

[31] In these cases, however, the choice between use of manufacturing costs and use of selling price as the basis of recovery has taken the form, not of a choice between two alternative definitions of cash value, but rather of a willingness to apply or disregard the so-called limiting clause of the policy. See *infra* pp. 394–401.

[32] See Texas Moline Plow Co. v. Niagara Ins. Co., *supra* note 28, *infra* note 79, where the court, in awarding replacement cost rather than the higher selling price, did so expressly on the ground that the insured had been able to replace the property in a "reasonable time"; *cf.* International Harvest. Co. v. Ry. Co., 186 Iowa 86, 172 N.W. 471 (1919), a damage case, where for the destruction of harvesting machines in the hands of a dealer, the court intimated that selling price and not replacement cost might be the test were it to appear that the plaintiff could not replace in time to effectuate his spring sales. The rendering of such a decision under a fire policy might be discouraged by the existence of profits insurance of which the insured might have availed himself. However, a manufacturer might also take out separate profits insurance, and yet the cases have held that a manu-

insured could show clearly that the usual assumption of a court that "replacement in kind necessarily accomplishes complete indemnity"[33] does not hold under the peculiar fact situation.

Just as there are situations where the recovery of replacement cost of goods destroyed in the hands of a dealer would undercompensate, so there are situations where it would have the contrary result. These are cases in which the owner would not have been able to sell the goods even at their cost of replacement to him, either because of a sudden fall in the demand for goods of that type and quality (let us say, changing fashions) or because the particular dealer was about to go out of business and would have been obliged to sell his stock at a sacrifice sale. Few cases of this type have arisen, and it is difficult, therefore, to generalize as to the rule which a court would be likely to adopt under the peculiar circumstances. Where the inability of the dealer to sell the goods at a price equal even to replacement cost is attributed to the depreciation in the value of the goods "as goods" (either physical depreciation or obsolescence), it has been held that this depreciation must be deducted from replacement cost as a measure of the cash value.[34] Where, however, the difficulty lies in the fact that the dealer has not been successful in business and is obliged to wind up, it is doubtful whether a court would take this fact into account in its charge to the jury. While it is indeed true that goods in the hands of a failing business organization are worth less than the same goods in the hands of a successful organization, this circumstance would very probably be disregarded by a court, which usually thinks of the value of a commodity as something more or less objective and intrinsic rather than as determined by the peculiar selling power of the owner of the property. On this latter point, however, we can only speculate, as there are no available cases.[35]

Accepting replacement cost rather than selling price as the normal measure of damages, we are still called upon for a more exact definition of this cost. One question is whether the cost should be taken to mean the normal or usual cost of replacing in the market available to the general class of dealers in question, or whether it should be the probable replacement cost to the particular person who is insured.

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facturer's recovery for the destruction of his product under a mere standard fire-insurance policy might include the profits that would have been realized but for the fire.

[33] McAnarney v. Newark Fire Ins. Co., *supra* note 3.

[34] Grubbs v. N. C. Home Ins. Co., *supra* note 28.

[35] For an analogous problem under the law of bankruptcy, See Chap. XXII

Ordinarily these two figures would be the same. Suppose, however, that a retail dealer is in a position, by virtue of a peculiarly friendly business connection, to purchase directly from a manufacturer at the manufacturer's selling price. Will he be permitted, under the interpretation of cash value, to recover the wholesale price which his fellow dealers are obliged to pay, or will he be limited to the recovery of the lower price at which he himself is able to replace the lost property? So far as we are aware, there is no reported case on this point.[36] If such a case did arise it might well be decided in one way by a judge who was alert to prevent a recovery in excess of complete indemnity, and in another way by a judge who was impressed with the necessity for fairly standardized measures of damages in the interest of administrative convenience.

A still further question as to the interpretation of replacement cost when accepted as the measure of recovery concerns the exact time as of which the replacement is supposed to be made. The standard policies provide that the damage shall be measured by the cash value of the property *at the time of the fire.*[37] This provision, however, is occasionally ambiguous. In *Liverpool, London & Globe Insurance Co. v. McFadden*,[38] 40,000 bales of cotton were destroyed. The fire commenced at about 6 o'clock in the morning, but the cotton which was stored in a warehouse was not actually destroyed until 4 or 5 hours later. The price of the cotton, as shown by the market quotations on the Exchange, was 8.40 cents per pound just prior to the fire but rose to 8.55 cents per pound as a result of the news of the impending destruction of such a large quantity of cotton. The question in the case was whether the cash value of the cotton should be computed at the time when the fire commenced or at the time of the actual destruction. The court awarded the higher price that prevailed at the later hour, on the ground that "the insured, if called upon by

[36] *Cf.* Aubertin v. Northern Assn. Co., 37 Quebec K.B. 349 (1924). The plaintiff was an agent of the Willys-Knight Company and had purchased a car at $3,000, wholesale price. The retail price was $4,000. The automobile was insured against loss by fire by defendant company. The court held that the basis of valuation was the retail and not the wholesale price. It does not appear, however, whether the insured might have replaced at wholesale or retail price. Nor is the language of the policy set out.

[37] It has sometimes been contended by the insured that recovery under a standard fire-insurance policy should be based, in effect, on the value of the property at the time when the policy was written despite a fall in value at the time of the fire. In one case, Commonwealth Ins. Co. v. Sennett Barr & Co., 37 Pa. 205 (1860), such a view had possibly been taken by a lower court only to be repudiated by the appellate court. See *infra* note 43.

[38] 170 Fed. 179 (C.C.A. 3rd, 1909).

business necessities to replace what he lost, having just so much more to pay for it," must be awarded that sum to be made whole.

B. Manufactured Goods Destroyed in the Hands of a Manufacturer.

Following the principle generally accepted with respect to goods destroyed in the hands of a dealer, by which recovery is limited to cost of replacement rather than to selling price, one might expect that the value of manufactured goods destroyed in the hands of manufacturers would be measured by the cost of manufacturing similar goods rather than by manufacturer's selling price. Most of the cases, however, hold that cash value is to be measured here by the manufacturer's current selling price.[39]

The reasons for the courts' apparent departure in these cases from the replacement-cost rule can only be guessed at in the absence of any thoroughgoing discussion in the reported opinions. One possible explanation is that manufacturing cost is difficult to estimate and that current selling price at the time of the fire is generally much easier to ascertain.[40] Another plausible reason is that in the majority of cases a manufacturer who has suffered a fire loss of his merchandise may be unable to remanufacture the stock in his own factory in time to avoid missing his market. The chances are that the factory itself will have been destroyed or damaged by the fire, so that much time will be lost before it can resume its normal working condition, to say nothing of making good for lost time. Whether a court would be willing to consider the circumstances of the particular case if these circumstances were raised in the pleadings, with the result that it might in some cases allow only manufacturing costs and in other cases selling price, is a question unanswered by the reported cases. All that can be said, therefore, is that in the cases so far reported the manufacturer has been able to recover

[39] Boyd v. Royal Ins. Co., 111 N.C. 372, 16 S.E. 389 (1892); Birmingham Fire Ins. Co. v. Pulver, 126 Ill. 329, 18 N.E. 804 (1888); Hoffman v. Aetna Fire Ins. Co., *supra* note 2. We are referring here simply to the measure of "actual cash value" of the property. As is noted later, however, the courts have on occasion limited a manufacturer to recovery of his manufacturing costs on the ground that the lower award was called for by the limiting clause in the New York type of standard policy.

[40] The fact that courts, in insurance cases just as in damage cases, have generally preferred to use some kind of a *market* value whenever this has seemed feasible, may help to explain their readiness to use replacement costs as the measure of recovery in dealer cases at the same time that they reject replacement cost in manufacturer cases. For in the first type of cases, replacement cost is identified with a market value (the value on the market in which the dealer makes his purchase), whereas in the second type of cases replacement cost (by remanufacture) is not *any kind* of a market value. See Chap. XIII.

his selling price[41] as a measure of cash value, unless prevented from so doing by the interpretation of the limiting clause in his policy.[42]

The problem of valuing goods which have deteriorated in the hands of a manufacturer, either through physical depreciation or through obsolescence, has apparently never been discussed in the reported cases.[43] There is no reason to doubt, however, that deterioration of all

[41] Only one of the cases discusses the meaning of selling price, and it was there held that a deduction for cost of selling was proper; that is, *net* selling price was the accepted criterion. Boyd v. Royal Ins. Co., *supra* note 39.

[42] As will be noted later, however, the courts in applying this limiting clause have sometimes taken into account the question whether or not a manufacturer could have replaced his goods in time to avoid losing his market.

Fire insurance adjusters in their actual practice of adjusting losses outside of the courtroom frequently take into account the question whether or not an insured manufacturer could have replaced his stock in time to avoid missing the market. We are informed, for example, that among adjusters in the southern states it has been a rule of thumb, in the case of the destruction of lumber in the hands of a mill-owner, to settle on the basis of the selling price of the lumber where the mill had been destroyed simultaneously with the destruction of the lumber but to settle on the basis of manufacturing costs where the mill was still intact and was, therefore, available for an immediate replacement of the destroyed lumber. It may also be noted that the practice of adjusters in settling for manufactured goods in the hands of a manufacturer differs to some extent as between industries and as between communities. With respect to losses of sugar, for example, the general policy is to pay manufacturers on the basis of their selling prices. On the other hand, with respect to clothing manufacturers in New York City it has been the practice to settle on the basis of estimated manufacturing costs of the clothing. One possible reason for the less favorable rule (*i.e.*, less favorable to the manufacturers) in New York is the fact that New York manufacturers are said to be peculiarly indisposed to litigate their legal right to recovery of full selling price because of their awareness of the extreme costs and delays of a lawsuit in the New York judicial districts.

[43] The nearest approach that we have found to a case in point is Commonwealth Insurance Company v. Sennett Barr & Co., *supra* note 37, where reaping and mowing machines had been destroyed while in the hands of the manufacturer. The insurance company contended for a valuation below manufacturing cost on the ground that the machines were of defective construction and hence worth only scrap value. The trial court, in holding that manufacturing cost was the proper test, ruled that evidence of the alleged faulty principle of construction was relevant only if the manufacturers *knew* of this defect when the insurance policy was issued. In reversing this holding, the upper court ruled that the evidence of defective construction should be considered as bearing on the value of the machines at the time of the fire, and criticized the lower court for its apparent assumption that the value *as at the time when the policy was written* should govern the recovery. It also indicated that the lower court was in error in assuming, apparently, that manufacturing cost was the proper basis of recovery, simply because the policy contained an option giving the insurance company the right to replace the property if it so desired.

types would be taken into account in the valuation. Where the loss is measured by estimated selling price, this price would itself reflect a fall in value due to all types of depreciation, and the allowance for depreciation would simply present itself as a question of the evidence bearing on the fair selling price of the articles.

C. Personal Property Held for Use.

This category includes property which the owner himself, in the normal course of events, would have used either for the production of other goods (for example, lumber used in the manufacture of wagons or tools and machinery used in the manufacture of clothing) or for his own consumption or enjoyment (furniture in the home, family portraits, flour for domestic consumption).[44] Generally the measure of recovery is the cost of replacing on the market minus deductions for depreciation. For example, where the insured, a publishing company, sued for the loss of ten linotype machines of a special make, which could be replaced only from the manufacturers, the measure of loss was the cost of so purchasing the machines.[45] Similarly where grain was destroyed, the market price at the time and place of destruction (*i.e.*, the cost of replacement) measured the loss.[46] And where lumber which was used in the manufacture of wagons was destroyed, it was held that the cost of purchasing this lumber at the time and place of the fire fixed the amount recoverable.[47]

By far the greater portion of cases falling in this category deals with the loss of personal effects, such as clothing, household furniture,

[44] Some of the property brought under this heading, namely, equipment, would be placed in the legal category of "real estate" if it were deemed to be in the nature of a fixture. For the purposes of valuation, however, the legal distinction between real and personal property is seldom significant, and we are, therefore, using the term "personal property" in a loose sense to cover all types of insurable property other than buildings. See, however, *infra* note 58, for a case suggesting the use of different rules of valuation as between real and personal property.

[45] Post Printing & Publishing Co. v. Ins. Co. of No. Amer., 189 Pa. 300, 42 Atl. 192 (1899). The publishing company had purchased the machines from the Mergenthaler Linotype Co. But from the contract of purchase it was difficult to tell whether the sale was outright or conditional. The insurance company argued that the arrangement was a conditional sale, that the title to the machines was in the manufacturer, and that the cost of replacing to the manufacturer was only $10,000. The court, however, held that the machines were the property of the publishing company and that the cost of replacing them was $30,000, the amount which it would take to repurchase from the manufacturer.

[46] Savage v. Corn Exch. Ins. Co., 36 N.Y. 655 (1867).

[47] Western Assurance Co. v. Studebaker Bros. Manuf. Co., 124 Ind. 176, 23 N.E. 1138 (1890).

and utensils. The peculiar common characteristic of this highly diversified class of property lies in the fact that these articles can seldom be resold by their owners except at a sacrifice price—a price generally below what it would cost the owner to replace even in a secondhand market, to say nothing of a market for new commodities. As a result, the situation which is true in the normal case of goods held for sale is precisely reversed in this case; for here it is generally to the interest of the insured to recover replacement cost, while it is to the interest of the insurer to pay only selling price. Clearly, however, selling price would normally result in much less than full indemnity, while replacement cost to the insured, on the other hand, would often result in over-indemnity unless some deduction is made from replacement cost new in order to take account of depreciation.

The fact that selling price on the one hand and replacement cost new on the other hand would violate the principle of indemnity has been clearly recognized by the courts in their holdings. As to selling price, they have uniformly held that the amount for which the owner might have sold his property is not the proper measure of his recovery,[48] although they have occasionally allowed testimony as to the price for which the owner could have sold to be admitted as *evidence* of cash value.[49]

Recognizing that selling price is not a fair criterion, the courts have generally fallen back on replacement cost to the insured as the chief element to be considered, with allowances, however, for depreciation and obsolescence.[50] To be sure, replacement cost minus depreciation

[48] Johnston v. Farmers Fire Ins. Co., *supra* note 26; German Ins. Co. v. Everett, *supra* note 4; So. Nat. Ins. Co. v. Wood, 63 Tex. Civ. App. 319, 133 S.W. 286 (1910); Sun Fire Office v. Ayerst, 37 Neb. 184, 55 N.W. 635 (1893); Globe & Rutgers Ins. Co. v. Winter Garden Co., 9 F. (2d) 227 (C.C.A. 2d, 1925).

[49] Detroit Fire & Marine Ins. Co. v. Boren-Stewart Co., 203 S. W. 382 (Tex. Civ. App., 1918); Joy Wright & Hudson v. Security Fire Ins. Co., 83 Iowa 12, 48 N.W. 1049 (1891): "The property in question consisted of old or second-hand furniture, the market price of which is usually very difficult to establish. It cannot be said to have a fixed market value, and we think that the price for which it was offered by the owner is at least competent evidence to be considered by the jury. If such an offer is accepted, it would seem quite conclusive that the property was worth the amount of the offer. If not accepted, it would be evidence tending to show that the property was not worth more than that for which it was offered."

The admission of selling price as *evidence* is clearly justified on the principle of indemnity, since the price for which a user could sell his property, while it does not necessarily indicate its full value to him, does at least indicate the lower limit of its value to him.

[50] City of De Soto v. Ins. Co., 102 Mo. App. 1, 74 S.W. 1 (1903); Boise Ass'n of Credit Men v. Ins. Co., *supra* note 28; So. Nat. Ins. Co. v. Wood, *supra* note 48; Johnston v. Farmers Fire Ins. Co., *supra* note 26.

has generally been accepted formally only as *evidence* of the value of the property rather than as the measure of damages itself. The value of the property to the owner rather than its replacement cost per se seems to be the accepted goal. In practice, however, testimony of replacement cost (or of original cost as an indication of replacement cost),[51] together with testimony of wear and tear, and occasionally of obsolescence, has generally been the only type of evidence that has gone to the jury or else has been so stressed that it must have been dominant in the minds of the jury.

Although the object of the court seems to be in a general way to approximate the value of the property to its owner as distinct from either its selling price or its replacement cost per se, this statement is subject to important qualifications. The first qualification is suggested by the accepted doctrine in the law of damages to the effect that no allowance should be made for sentimental value. No reported case on this point has been found in the field of fire-insurance losses. But it is the general opinion of adjusters—and there seems to be no reason to doubt the accuracy of this opinion—that the same rule would be applied in these cases that is applied in the ordinary damage case.[52] The second qualification to the statement that value to the owner is the accepted principle is required because of the well-recognized interpretation of the standard fire-insurance policy to the effect that incidental damages resulting to the owner by virtue of a sudden loss of his property are not covered by the policy. The destruction of

[51] In valuation as a measure of insurance losses, no less than in other types of judicial valuation, the question may be raised whether the original cost of the property to its owner may influence the valuation *directly* or whether it is relevant only in so far as it bears on the probable current replacement cost. So far as one can judge from the reported opinions in fire-insurance cases, the courts have uniformly held that original cost has nothing to do with the case except as *evidence* of replacement cost. Consistently with this position, courts have held that original cost is not even admissible as evidence unless there is good reason to suppose that current prices have not materially changed since the time of the original purchase, or else unless the extent of this change can be taken into account. *Cf.* Merchants Ins. Co. v. Frick, *supra* note 23. There is reason to believe, however, that juries in their actual awards are more directly influenced by testimony of original cost than would be justified on the assumption that replacement cost alone is the real desideratum. The fact that the owner of the property actually incurred an expense of so many dollars in its purchase may well tend to make a jury feel that he should be reimbursed to this extent.

[52] Lloyd v. Haugh, 223 Pa. 148, 72 Atl. 516 (1909); Lake v. Dye, 232 N.Y. 209, 133 N.E. 448 (1921); *cf.* The H. F. Dimock, 77 Fed. 226 (C.C.A. 1st, 1896); but *cf.* Wamsley v. Atlas Steamship Co., 50 App. Div. 199, 63 N.Y. Supp. 761 (1st Dept., 1900); Bateman v. Ryder, 106 Tenn., 712, 64 S.W. 48 (1901); Green v. Boston & Lowell R.R., 128 Mass. 221 (1880).

furniture in a residence, for example, may be expected to result in great temporary inconvenience to the owner of the property and even in a loss of rent if the owner is about to rent the premises. Under the standard fire-insurance policy, however, the owner could not collect more than the replacement cost of the furniture (with deductions for wear and tear) even though he might gladly have paid much more than replacement cost in order to avoid incurring the loss. A property owner may insure against these incidental losses by rental or rental-value insurance.

Although replacement cost is generally accepted as the dominant test of the cash value of the property, the necessity sometimes arises of choosing between cost of replacing new minus depreciation, and cost of replacing in a secondhand market with articles of a similar degree of wear and tear. Theoretically these two methods of estimating value might be supposed to reach the same result, except that the second method would attempt to arrive directly at the figure which the first method reaches in two stages. In practice, however, the use of replacement cost minus depreciation is almost certain to result in a materially higher figure than the use of replacement cost in the secondhand market. This is due to the fact that "depreciation," while it may include not merely wear and tear but also obsolescence, is never thought of as taking into account the additional loss of market value that normally takes place in a secondhand market due to the fact that this market is generally not well organized and also to the fact that there is a general prejudice against secondhand goods. A clear illustration of this situation is that of used clothing. A suit of clothes which might be bought new for $100 could not be sold by secondhand-clothing dealers for more than a fraction of this amount even though it had suffered very little wear and tear; yet its original owner might value it for only slightly less than the $100 which he paid for it. In a situation of this kind, the position of the courts has been the eminently reasonable one that the replacement cost should be computed in that market in which the owner might normally be presumed to replace in view of the usual practice with respect to goods of the type in question. Where property is of a peculiarly personal nature, such as used clothing, courts have uniformly held that cost of replacement in a secondhand market is not the test, and it is even doubtful whether this cost would be admissible as *evidence* of the value of the clothing.[53] Where, on the other hand, the property is not of a personal nature and where there are no cogent reasons of convenience and prejudice why the owner should not replace in a secondhand market, courts have held

[53] See cases cited *supra* note 48. Compare the damage cases, Chap. XIV, subsection on "Secondhand Consumers Goods."

that the cost of replacing in such a market is admissible in evidence of the value.[54]

In those cases where replacement cost new is admitted as evidence of the value of the property, the question has arisen as to what forms of depreciation should be deducted. All the cases are clear that physical depreciation must be taken into account,[55] and the only doubt concerns a further deduction for obsolescence or inadequacy. On this point there have been very few reported cases, but these have all held that depreciation must be considered in its broadest sense. For example, in the case of used patterns, molds, and designs used as equipment by a manufacturer it has been held that their replacement cost new is not a fair test and that their obsolescence as well as their physical depreciation must be taken into account.[56] In another case, *Prussian National Insurance Co. v. Lawrence,* [57] the saloon equipment which had been destroyed by fire was valued by arbitrators at $1,000 in spite of the fact that its "sound value" (presumably its replacement cost new minus physical depreciation) was found by them to be $3,000. This low valuation was justified by the arbitrators on the ground that the passage of a local prohibition statute after the policy had been written but prior to the fire, had caused the value of the fixtures to fall by this amount. In an appeal in equity the lower court set aside this award and its action was affirmed on appeal. The upper court, however, based its affirmance expressly on the ground that the fixtures

[54] Thus in adjusting automobile losses under policies which obligate companies to pay "actual cash value," the majority rule fixes the basis of valuation at the secondhand market value. The cases do not state whether market value here means what a car user could have sold the car for, or what he could have bought a similar car for. It is probable, however, that the latter definition would be accepted. Automobiles are covered not under the ordinary standard fire-insurance policy but by a special type of policy. In these policies cost new less depreciation forms the upper limit, and cash value is the generally stated quantum of liability. Due to the wide use of valued policies the reported cases are few. Gibson v. Glens Falls Ins. Co., 111 Neb. 827, 197 N.W. 950 (1924); Spivy Johnson Portrait Co. v. Belt Automobile Indemnity Assn., 210 Ala. 681, 99 So. 80 (1924); Simpson, *Law Relating to Automobile Insurance* (2d ed., 1928), Chap. 8.

[55] The difference between property new and in its used condition must be recognized. Boise Assn. of Credit Men v. Ins. Co., *supra* note 28. Cost and condition are always considered, *supra* note 47. So true is this that some courts state the measure of loss, in the absence of a market value, not in terms of any other *value,* but in terms of original or replacement cost less depreciation. Globe & Rutgers Ins. Co. v. Winter Garden Co., *supra* note 48.

[56] Michels v. Western Underwriters Assn., 129 Mich. 417, 89 N.W. 56 (1902); Security Printing Co. v. Conn. Fire Ins. Co., 209 Mo. App. 422, 240 S.W. 263 (1922).

[57] 221 Fed. 931 (C.C.A. 4th, 1915).

might have been sold in another state for a price that would net more than $1,000 after deducting transportation costs. It did not question the propriety of an award for less than replacement cost minus physical depreciation where the value had obviously fallen as a result of the passage of the prohibition statute.

D. Valuation of Buildings.

A logical classification of types of insured property would require us to divide buildings no less than chattels into two groups, namely, those held for sale and those held for the use of the owner. But since no reported cases have been found which have discussed the peculiar problem of valuing buildings held for sale in the hands of a real-estate operator or speculator, it is unnecessary to make this subclassification. Another possible subdivision would be into buildings for commercial purposes and buildings for residence purposes, but the paucity of cases on residential property makes this division also pointless.

Since the cases generally go on the assumption that the building is held for use rather than for sale, the problems of valuation involved in these cases would seem to be the same in principle as those that we met with in the preceding section, which considered personal property in the hands of a user. The mere fact that buildings fall into the legal class of real property, whereas most other insurable articles fall into the class of personal property, seems to have no bearing on the problem of valuation for insurance purposes, and the courts themselves have not made any such artificial distinction.[58] It is conceivable, however, that courts, under the influence of tax-appraisal methods, may have developed standardized rules for valuing buildings which they would not apply in the valuation of chattels; and this possibility must be carefully canvassed because of a prevalent assumption that for fire-insurance purposes the measure of recovery is the so-called physical value of the building (that is, its replacement cost minus physical depreciation) rather than its commercial value. In fact, this assumption raises the most hotly disputed question in the whole field of valuation for insurance purposes. Should a building whose rental

[58] A possible exception may be noted in jurisdictions which have "valued-policy" laws as to real property. Here it has been held that a building purchased for removal purposes, where the purchaser had no right to use the building in connection with the land on which it then stood, was to be regarded as personalty and not as realty within the purview of the statute. American Cent. Ins. Co. v. Wise, 295 S.W. 1109, 69 Ins. L. J. 865 (Tex. Civ. App., 1927). The effect of this decision was to place on the insured the burden of showing the value of the building. An opposite decision would entitle the insured to the face value of the policy.

value or sale value has fallen to a point far less than replacement cost, nevertheless be valued at its replacement cost, or should it be valued at some lower figure which represents its current worth to its owner?

On one phase of the question the courts have always been clear. They have invariably insisted that an old building may not be valued at its replacement cost new[59] except after the deduction of an allowance for physical depreciation.[60] This doctrine is so well recognized that the parties desiring a high valuation no longer take the trouble to challenge it before a court. The real bone of contention, however, takes the form of the further question whether losses in value other than those caused by mere wear and tear can be taken into consideration. In a contest as to the measure of recovery for the loss of obsolete buildings, it has been the repeated contention of the insured that the so-called physical value of the building is the measure of recovery, whereas it has been the insistence of the insurer that cash value with reference to *all* factors bearing on the current economic value of the property shall be taken into account. Oddly enough, the same issue has on occasion arisen

[59] By replacement cost is meant what it would cost to replace a new building as of the date of the fire. The market value of new lumber at that date is therefore admissible as evidence of the building costs. Cummins v. German Ins. Co., 192 Pa. 359, 43 Atl. 1016 (1899). The cost of rebuilding at the date of the trial was held inadmissible in Caraher v. Royal Ins. Co., 63 Hun 82, 17 N.Y. Supp. 858 (4th Dept., 1892). Where, however, it was further shown that the prices of building materials had not seriously fluctuated since the date of the fire, cost at the time of the trial was admitted. Cummins v. Insurance Company, *supra*. In one case it has been held that the mere fact that material costs were unusually high at the time of the fire was not a reason for declining to accept them in estimating the value of the building. Providence Wash. Insurance Co. v. Gulinson, 215 Pac. 154 (Colo., 1923). It may be surmised that a court might reject or modify building costs that it deemed to be highly abnormal due to temporary speculative conditions of the market.

[60] Although courts invariably instruct a jury to take into consideration the depreciated condition of a building or other property in determining its value for fire-insurance purposes, they have been notably silent as to the way in which the amount of depreciation shall be ascertained and measured. Sometimes the jury is told simply to take in consideration the condition of the property at the time of the destruction. Brinley v. National Ins. Co., 11 Metc. 195 (Mass., 1846). Sometimes it is instructed to compare the property destroyed with similar property new. Aetna Ins. Co. v. Johnson, 74 Ky. 587 (1875). Sometimes it is told to consider the age, extent of use, and condition of the property at the time of the fire. Boise Assn. of Credit Men v. Ins. Co., *supra* note 28. In the insurance cases, one notes a complete absence of any such theoretical discussion of the nature and measurement of depreciation as one finds in the valuation of property for rate-making purposes. In the former type of cases, for example, we have not found a single mention of the relative merits of the straight-line as distinct from the sinking-fund basis of calculating depreciation.

with the party litigants reversed, the insurance company contending for the higher "physical" value and the insured contending for the lower "real" value. This apparent anomaly has arisen by virtue of the coinsurance clause, which makes it to the interest of the insurance company to minimize the amount of damage done to a building but to maximize the value placed on the entire building.[61]

Although some judicial utterances support the view that replacement cost minus mere *physical* depreciation is to be taken as the measure of cash value in the loss of a building, they seem to be nothing more than dicta and are controverted by an increasing number of decisions to the opposite effect. Before discussing the cases, it is important to point out a serious misconception which is largely responsible for the opinion that nothing but physical depreciation must be deducted from replacement cost new. This misconception arises from the fact that the courts have repeatedly declined to accept the *market* value of a building (by which they have meant the market value of the entire property minus the market value of the vacant land) as the proper measure of recovery.[62] This position is quite consistent with the principle of indemnity, for in a large number of cases the market value of a used property, in the sense of the price for which the owner could have sold it, does not represent the full value of that property to its owner. Buildings, like chattels, are often peculiarly adapted to the uses of their existing owners or occupiers. Consequently, they can be sold only at a price which takes into account the lack of adaptation of the property to any other user. The courts, in refusing to accept liquidation price as a proper measure of recovery, are acting, therefore, in accord with the principle of indemnity. Some commentators, however, and even some judicial opinions, have read too much into this refusal to accept market value as the test and have jumped to the quite unjustifiable inference that because market value is rejected, therefore the so-called physical value of the property must

[61] The coinsurance clause becomes important in the case of partial destruction of a building. Assume a case where both parties concede that there has been a damage of $100,000 to the building. The policy is for $100,000 and provides that the insured is a coinsurer to the extent of the uninsured value of the building. If the insurance company can show that the value of the building before the fire was $200,000, its liability will be for only one-half of the damage sustained. But if the insured shows that the building was worth only $100,000, he will recover the full amount of the loss.

[62] Aetna Ins. Co. v Johnson, *supra* note 60; Stenzel v. Pa. Fire Ins Co., 110 La. 1019, 35 So. 271 (1903); Citizens Bank v. Fitchburg Ins. Co., 86 Vt. 267, 84 Atl 970 (1912); Smith v. Allemannia Ins. Co., 219 Ill. App. 506 (1920); Boise Assn. of Credit Men v. Ins. Co., *supra* note 28; State Ins. Co. v. Taylor, 14 Colo. 499, 24 Pac. 333 (1890); Merchants Ins. Co. v. Frick, *supra* note 23.

take its place. As a matter of fact, there is no such dilemma in the situation, for it is quite possible that a court may reject selling price as the criterion of value while yet insisting that all available evidence, including facts as to obsolescence, must be taken into account in order to reach the probable value of the building *to its existing owner.* As will be noted presently, virtually this third alternative has been accepted by the New York Court of Appeals in a recent decision.

Coming now to the cases, we may note first a case that has frequently been cited as holding that the measure of cash value under a standard policy is replacement cost minus physical depreciation without reference to obsolescence: *Smith v. Allemannia Fire Insurance Co.*[63] It arose under a policy containing a 90 per cent coinsurance clause and it was, therefore, to the interest of the insured, who was plaintiff, to estimate the damage suffered by a partial destruction of his building at a high amount but to estimate the total value of the building at a low amount. The total amount of his insurance was for $86,000, and he claimed a loss of about $87,000 on his building, the total value of which he set at $90,000. The defendant insurance company insisted, on the one hand, that the estimate of loss was excessive and, on the other hand, that the valuation of the building was insufficient. Its claim was that the building was worth about $150,000. In the lower court the plaintiff recovered about $79,000, and the defendant appealed. As the upper court pointed out, it was imperative for the plaintiff to establish that $86,000, the amount of his insurance, was at least 90 per cent of the value of the building, since a failure to do so would result in the insured's being obliged to share a proportionate part of the loss. The main question, therefore, turned on the valuation of the entire building, the insured contending in the appellate court that "actual cash value" meant fair market value, while the insurer contended that it meant reproduction cost less depreciation for age. In reversing the decision and remanding the case to a lower court for retrial, the upper court stated its conviction that the value of the entire building was much greater than the amount set by the plaintiff. It supported this conviction by the assertion, based on the authority of Cooley on Insurance, that "appellee under his policy is entitled to be indemnified since actual cash value means reproduction value less depreciation for age and not market value."

The opinion in this case might be construed as implying that reproduction cost modified only by physical depreciation is the proper measure of recovery, even when the resulting figure greatly exceeds the current commercial value of the property. The case, however, is by

[63] *Supra* note 62.

no means clear, since the court did not explain just what it included under the heading "depreciation for age," a phrase that might well have included a deduction for obsolescence and inadequacy. It is still more confused by the apparent neglect of the point, stressed in the previous paragraph, that the antithesis, made by Cooley, between market value and depreciated replacement cost does not suggest all the alternatives in the case.

The question as to how far replacement cost should be modified in view of other evidence of value was raised again in another case involving coinsurance: *Citizens Savings Bank & Trust Co. v. Fitchburg Mutual Fire Insurance Co.*[64] In this case, also, the insurer, who wanted to establish a high valuation for the building, insisted that the proper measure of the value was replacement cost minus depreciation (however caused). The insured, who contended that cash value was the measure, introduced in the trial court without exception the gross and net income earned through the rental of his building during the past 3 years. In support of this he introduced over defendant's objection evidence of the upkeep cost and taxes during the 3-year period, and he also presented testimony by experts as to what would constitute a fair rental on his property and as to their opinion of a fair cash value. The trial court refused to instruct the jury that reproduction cost new minus depreciation however caused was the test. In the argument before the appellate court the plaintiff, while conceding that reproduction cost was relevant *evidence*, denied that it could be accepted as an *exclusive* test of cash value. The case was reversed on other grounds, but the appellate court said that the plaintiff had correctly contended that cash value was the proper basis and that *any* relevant evidence on this point was admissible. Reproduction cost minus depreciation, said the court, was not in itself the measure of value but was only the upper limit as fixed by the limiting clause in the policy. In proof of actual cash value the earnings in the form of rentals were admissible as evidence, although the capitalized rentals could not in themselves measure the value of the building in view of the fact that they represented in part a rental of the land, which was of course not insured.[65]

The relevance of rental value as evidence of the fair cash value of a building was also at issue in *Merchants Insurance Co. v. Frick.*[66]

[64] *Supra* note 62.

[65] "The rents received from tenants of a building are earned in part by the land on which it stands, and a determination of the value of a building on the basis of its income would give it an increased value because of a proprietary interest not insurable and not affected by the loss." 86 Vt. 267 at 274.

[66] *Supra* note 23.

In this case the insured had erected a house at a cost of about $7,000. The land upon which the building stood was leased to the owner of the building at a rental of $480 a year. Taxes, insurance, and upkeep brought the total expenses of maintenance to roughly $1,000 a year, whereas the annual rentals realized by the owner had amounted to only $720. From these facts it would seem that the building had no commercial value whatever unless it might be inferred that a material increase in earnings could be expected in the future. The lower court, in its instruction to the jury, stated that actual cash value was the proper test but that this did not mean current market value. The evidence of the actual cash value, as admitted and stressed by the lower court and as apparently accepted by the jury, was original cost minus physical depreciation. On appeal by the insured the upper court reversed the award on the ground that the reasonable *replacement* cost rather than the *original* cost was the proper test. It said: "We take it that the sound and only practical ordinary rule is to ascertain how much money will be required to restore the property burned. . . . Cash market value cannot be the test."

Although this holding would seem to imply the acceptance of replacement cost despite the fact that the actual value of the building to the owner was clearly very much lower, the force of the opinion is modified by the further comment of the court that the rental value of the property might have been shown by defendant on cross-examination. The import of the case is by no means clear, although from the meager facts as stated it would seem that the court here leaned toward the acceptance of physical replacement cost as the normal test.

In *State Insurance Co. v. Taylor,*[67] the court held that several different types of evidence were admissible. This evidence included the "value of the building on the market" (by which was apparently meant the difference between the selling price of the whole property and the selling price of the land alone), although the court stated that this value alone was not a safe criterion. The measure of loss was held to be the "actual value," taking into consideration cost of replacing, age, condition, etc. This opinion is too indefinite to prove much, but it indicates the unwillingness of a court to accept any one fixed standard, such as replacement cost minus physical depreciation, to the exclusion of other possible tests of a fair compensation.

The most recent case involving the problem of depreciation other than mere physical depreciation, and also the most important case by virtue of the high prestige of the court, is *McAnarney v. Newark Fire*

[67] *Supra* note 62.

Insurance Co.[68] This case involved the measure of damages under the present form of the New York standard policy, which makes "actual cash value (ascertained with proper deductions for depreciation)" the measure of loss. The plaintiff had been a director of the Eagle Brewing Company, which at one time owned the property. After March, 1918, due to the passage of the National Prohibition Act, the buildings had fallen into disuse. In 1919 the plaintiff purchased the property from the company for $8,000. In January, 1920, policies insuring the buildings for $42,750 were taken out. The fire occurred in April, 1920. Trial was before a jury, to which the court submitted the written question: "What was the intrinsic or depreciated structural value of the buildings burned?" A verdict was rendered based on a value of $55,000, and the defendant appealed to the Court of Appeals, after a vain attempt to secure a reversal in the Appellate Division. Complaint was made that the trial court had committed error in rulings on evidence and in its charge to the jury. The trial court had refused to admit defendant's offer to prove that the plaintiff, when a director of the brewing company, had sought in vain to find a purchaser for the property; that the brewing company had directed the plaintiff to erect a sign on the premises advertising the property for sale for $12,000; that the plaintiff stated in an affidavit to the local board of assessors that the property had no value save for the production of malt and that the owners would sell for $15,000 but that the highest offer was $6,000. In charging the jury, the trial court had said: "Your answer shall not be the market value—shall not be the sum that the buildings would sell for, but what it would cost to build them—what it would cost to build them less depreciation proved in the case." This charge further stated that the fact that the malt could no longer be made and that, therefore, the building could no longer be used for any useful purpose was entirely immaterial, since "value" for the purpose of recovery was to be measured solely by cost of replacement less deductions for *physical* depreciation.

Before the Court of Appeals the insurance company contended that the market value of the building was the correct test, while the

[68] *Supra* note 3. The signal importance of this case is recognized by fire-insurance-company adjusters, who acclaim the holding as one for which they had long been praying. A close study of the preceding decisions, however, shows that the holding is not really revolutionary, but that it is simply the culminating expression of a growing judicial tendency, not merely in fire-insurance cases but in all valuation cases, to depart from so-called "physical values" in favor of economic values. Nor is the result of the precedent at all times favorable to the insurer, for in adjusting partial losses under policies containing coinsurance clauses, as we have seen, it is to the insured's benefit to have a low value placed upon the building.

insured insisted that the lower court was right in setting replacement cost minus physical depreciation as the proper test. In reversing the finding of the lower court, Judge Kellogg, speaking for a unanimous court, denied that either of the two contentions as to the measure of cash value was correct. As to market value, he pointed out that under the terms of the policy the insurance was limited to

". . . actual cash value (ascertained with proper deductions for depreciation) of the property at the time of the loss or damage." Value ascertained by market price is necessarily expressive of a suitable deduction for depreciation. If "actual cash value" were synonymous with "market value," the words in parentheses, to have force, would require depreciation to be twice subtracted. No such anomalous result could have been intended. In order that the parenthetical words should have force, therefore, "actual cash value" must be interpreted as having a broader significance than "market value."

In denying that market value is the proper test the court was simply following the earlier precedents which held, quite properly, that the price for which a building can be sold is no fair test of its value to the owner.[69] But the notable part of this decision is that the court went on to recognize that the other stated alternative, namely, reproduction cost minus physical depreciation, would err on the side of overcompensation just as the market-value rule would err on the side of undercompensation. Its opinion on this point deserves to be quoted at some length.

We do not agree . . . that, under the standard clause, the sole measure of damage was cost of reproduction less physical depreciation. . . . Where insured buildings have been destroyed the trier of fact may, and should, call to its aid, in order to effectuate complete indemnity, every fact and circumstance which would logically tend to the formation of a correct estimate of the loss. It may consider original cost and cost of reproduction; the opinions upon value given by qualified witnesses; the declarations against interest which may have been made by the assured; the gainful uses to which the buildings might have been put; as well as any other fact reasonably tending to throw light upon the subject.

In the case at bar the trier of fact, in considering cost of reproduction, was required by the policy to make proper "deductions for depreciation." The word (depreciation) means, by derivation and common usage "a fall in value, reduction of worth" (*N.Y. Life Ins. Co. v. Anderson*, 263 Fed. Rep. 527 at 529). It includes obsolescence (*Nashville, C. & St. L. Ry. Co. v. U.S.*, 269 Fed. Rep. 351 at 355; *San Francisco & P. S. S. Co. v. Scott*, 253 Fed. Rep. 854 at 855). An obsolete thing is a thing no longer in use. In determining the

[69] It may be added that we do not subscribe to Judge Kellogg's peculiar defense of this holding, as noted in the preceding paragraph—a defense based on a questionable construction of the ambiguous English of the statute.

extent to which these buildings had suffered from depreciation the trier of fact should have been permitted to consider that, owing to the passage of the National Prohibition Act, they were no longer useful for the purposes to serve which they were erected. It should have been permitted to consider their adaptability or inadaptability to other commercial purposes.[70]

It will be noted that the *McAnarney* case involved a building used for commercial purposes rather than a private residence. Whether the standard of replacement cost with allowances for mere physical depreciation would be more closely adhered to in the case of a private residence is a question on which it is possible only to speculate. In one or two opinions, including that of the *McAnarney* case, it has been suggested that the valuation of a residence presents problems different from those raised in the case of a commercial building;[71] but just what these differences are has not been stated. The most significant difference may lie in the practical difficulty of securing adequate evidence of the value of a residence to its owner other than by the measure of replacement cost minus physical depreciation. Of course, even with a residence, the factors of obsolescence and of lack of adaptation of a building to its environment may well be important; but the measurement of these factors would be especially difficult where the residence was in the possession of its owner and where no figures as to actual rentals could be introduced as evidence of current values.

Although the cases so far discussed, notably the *McAnarney* case, seem to point to the conclusion that any relevant evidence of the current value of the property to its owner may be introduced by way of proving that the cash value of the property is less than its reproduc-

[70] 247 N.Y. 176 at 183 *et seq.*

[71] The considerations affecting the value of a family residence and of an apartment house or office building are not entirely the same." Citizens Bank v. Fitchburg Ins. Co., *supra* note 62.

"The law of damages distinguishes between marketable chattels possessed for purposes of sale and chattels possessed for the comfort and well being of their owner. In the instance of the former it judges their value by the market price. In the instance of the latter it measures their loss, not by their value in a second-hand market, but by value of their use to the owner who suffers from their deprivation. The latter measure is employed in the case of household furniture, family records, wearing apparel, personal effects and family portraits [citing casesl. Doubtless the law should similarly discriminate between buildings used and usable for commercial purposes and buildings used and usable for residence purposes [citing the above excerpt from Citizens Bank v. Fitchburg Ins. Co.]. It might well be held that handsomely carved woodwork or other ornamental features, when found in a private home, have insurable value, whereas, when found in a factory, since they are not useful for factory purposes, they have no such value." McAnarney v. Newark Fire Ins. Co., 247 N.Y. 176 at 185.

tion cost,[72] there is one peculiar situation in which the courts up to the present time have taken a different position. This situation has arisen where the owner of real estate sells the land to another party but retains the right to remove the building if he so desires. Two cases of this nature involving the same piece of property but referring to different insurance policies arose at the same time in a Federal district court and in the Massachusetts Supreme Court.[73] In this instance the city of Boston had purchased ground from the plaintiff under an agreement that the owner might remove the buildings prior to a certain date and that otherwise the buildings would be forfeited to the city. After entering into this contract of sale but before turning over the property to the city, the plaintiff renewed his insurance policy on the building but without disclosing to the insurance company the contract which he had entered into with the city. Shortly afterwards the buildings were burned, and the insurance company refused to make any payment, alleging first that the insurance was void as a result of the failure of disclosure, and second that, even if the insurance were not void, recovery should be limited to the value of the buildings for removal purposes, which would, of course, be far less than their normal value. Both in the Federal and in the state courts the plaintiff was upheld in his contention that the policy was not void through his failure to disclose and also in his contention that the measure of recovery should not be limited to the removal value of the buildings. The Federal court commented as follows on the valuation problem:

> Again, defendants claimed that the rule of damages to be adopted should be the value of the buildings for the purpose of removal rather than their actual value. The true measure of damages is the real value of the property and not its relative value to the insured.[74]

A more lengthy discussion of this point was given by the Massachusetts Supreme Court. "Actual intrinsic value," it said, was the proper

[72] A question may be raised whether or not the difference in phraseology between the Massachusetts form of policy and the New York forms (the former specifying simply "cash value," and the latter, as noted in the McAnarney opinion, providing specifically for a deduction for depreciation) may lead to any distinction between the principles of valuation accepted by the courts. No indication of any such distinction can be found in the opinions.

[73] Washington Mills Emery Manufacturing Co. v. Comm. Fire Ins. Co., 13 Fed. 646 (C.C.D. Mass., 1882); Washington Mills Emery Manufacturing Co. v. Weymouth & Braintil Ins. Co., 135 Mass. 503 (1883); *semble*, German Ins. Co. v. Duncan, 140 Ky. 27, 130 S.W. 804 (1910).

[74] 13 Fed. 646 at 650.

measure of recovery rather than the worth of the property to its owner under the peculiar circumstances of the case.[75] The court admitted that this rule would here result in giving to the insured a profit as a result of the fire, but added:

> It often happens that the insured may gain an advantage by a fire, by reason of some collateral contracts or relations with other parties, *e.g.*, a mortgagee may insure his interest in a building and recover the amount of his debt even if his security seems insufficient.[76]

Oddly enough, the court then proceeded to reiterate the oft-repeated principle that an insurance contract is simply a contract of indemnity, asserting that the true test of indemnity is not "what the actual loss to the plaintiff is, or, in other words, to what extent he has suffered by the fire." The court here confused "indemnity" with an amount sufficient to permit *physical* restoration.

Whether or not a decision similar to that in the cases just noted would be upheld today is an open question, for there has been a distinct judicial tendency in recent years to guard more and more closely against overindemnity on the ground that such a safeguard is necessary to protect against the moral hazard. Certainly it would be difficult to find a clearer case than the *Washington Mills* case in which the insured would be under temptation to burn his own property in order to recover on an insurance policy. It is submitted, therefore, that the holding was an extremely unfortunate one and that it should be reversed whenever a similar situation arises.[77]

Effect of the Limiting Clause on the Measure of Recovery.

Up to the present point, the discussion has turned on the interpretation by the court of the meaning of "cash value" as that term is used in the various standard policies. It remains now to consider what, if any, effect on the measure of recovery results from the addition of the so-called limiting clauses in the old and the new New York types of policy. The presence of these clauses is designed in effect to base the recovery on cash value or on cost of replacement, whichever is less. Whether or not in practice, however, the limiting clause has any significance depends on the question whether it is ever made to apply in a case where a court would interpret cash value itself as being something higher than replacement cost. The preceding section has made

[75] In support of this position the court quoted from the Commentaries of Chancellor Kent, *Kent Com.*, Vol. III, p. 376.

[76] 135 Mass. 503 at 506.

[77] See *supra* pp. 21–22, for an earlier discussion.

it clear that a court is seldom disposed to measure cash value at any figure in excess of replacement cost new, although it is frequently ready to reduce the value below that figure by virtue of depreciation and other factors. There are a few cases, however, in which the cash-value rule, pure and simple, would seem to result in a larger recovery than replacement cost new, and it is in those cases that the limiting clause may have a possible effect.

Before an answer can be given to the influence of the limiting clause on the cash-value ruling, it is necessary to note precisely what this clause is interpreted to mean. The phrasing of the old New York policy differs at this point from the phrasing of the newer New York policy. According to the former, the actual cash value

> . . . shall in no event exceed what it would then cost the insured to repair or replace with material of like kind and quality.

According to the revised policy, the company

> . . . does insure to the extent of the actual cash value (ascertained with proper deductions for depreciation) of the property at the time of the loss or damage, but not exceeding the amount it would cost to repair or replace the same with material of like kind and quality, within a reasonable time after such loss or damage.[78]

We consider first the effect of the old limiting clause, reserving for later discussion the possible influence of the amendment.

With one noted exception,[79] the only cases in which the limiting clause has been invoked to reduce the measure of damage below what the court would call the "cash value" of the property, are cases involving manufactured goods destroyed in the hands of the manufacturer.

[78] The wording of this statute must disturb the lover of nice phraseology in view of the fact that the limiting clause is made to appear as a qualifying definition of cash value, whereas it is really a measure of recovery *alternative* to cash value.

[79] Texas Moline Plow Co. v. Ins. Co., *supra* note 28. The plaintiff was a dealer in plows, and his place of business was in San Antonio where the plows were destroyed. It was impossible to purchase or replace these plows at San Antonio, and the plaintiff therefore argued that cash value must be fixed at the price for which plaintiff might have sold the plows. The company argued that the policy limited recovery to the cost of replacing the plows. Whereupon the insured replied that he could not "then" replace them at any price and hence that the limiting clause did not apply. The trial court found that plaintiff had in fact replaced the plows within 30 days after the fire, and it awarded only replacement cost. The plaintiff appealed, and in affirming the lower court the upper court held the limiting clause to be applicable on the theory that "then" meant a reasonable time, and that under the circumstances plaintiff had replaced within a reasonable time.

The probable reasons why the limiting clause has not been involved in other litigated cases are that, with respect to goods in the hands of dealers, cash value itself is generally interpreted as limited to replacement cost, and that, with respect both to buildings and to chattels held for use, the factor of depreciation would generally reduce the estimate of cash value to a point below the limit of replacement cost new. In the case of manufacturer's goods, however, it has been held that cash value means the manufacturer's selling price rather than cost of manufacture, and the question has, therefore, arisen on several occasions whether the limiting clause may not be held to modify this rule by limiting recovery to manufacturing costs. The fact that the old New York policy specifically states "what it would cost *the insured*" to replace the property strongly suggests that manufacturing cost rather than cost of replacement in the market would be required.

Just such an interpretation of the limiting clause was accepted in *Standard Sewing Machine Co. v. Royal Insurance Co.*[80] In this case the witness for the plaintiff, who was the insured, had been asked to state what it would cost to replace the destroyed sewing machines with materials of like kind and quality. Before replying he asked whether he should answer that question as a manufacturer or as a purchaser in the market. The question was then rephrased so as to call for purchase price on the market. Defendant objected, and on an award of cost of replacement on the market he appealed. In reversing the award the upper court, after quoting from the language of the policy, said:

> It is evident that in his ruling as to the measure of damages, the learned trial judge did not properly construe this provision of the contract between the parties. The plaintiff was the "insured" and was the manufacturer of these machines. Under the clause of the policy just quoted the loss could "in no event exceed what it would then cost the insured to repair or replace the same with material of like kind and quality." The court failed to give due weight to this provision of the policy. The actual cash value of the property at the time of the fire was the measure of damages, but it could not exceed what it would cost the insured to replace it. This would exclude the market value of the property as a measure of damages and would permit the plaintiff to recover only what it would cost him, the insured, who was the manufacturer, to replace. The language of the policy is plain and unambiguous, and the court should have interpreted it and given the jury the measure of damages suggested.

The above case seems to be the only reported case in which a court has construed the limiting clause of a New York standard policy as pre-

[80] 201 Pa. 645, 51 Atl. 354 (1902).

venting a recovery of more than manufacturing costs.[81] All the other cases, in fact, seem to go the other way.[82] However, a study of the fact situation in these apparently contradictory holdings suggests that the cases are to be distinguished. In the *Standard Sewing Machine* case there was no evidence, so far as one can judge from the opinion, that the plaintiff sewing machine company could not have manufactured within sufficient time to avert a loss of his market.[83] In all of the other cases, however, it is made fairly clear that remanufacture could not take place except after an embarrassing length of time. While some of the opinions in these cases seem to say that manufacturer's selling price is *always* the rule, despite the presence of a limiting clause,[84] the actual decisions can be well reconciled with the view that, under a limiting clause, replacement cost by a manufacturer is accepted wherever remanufacture in a "reasonable time" is feasible but that replacement cost in the market (that is, manufacturer's selling price) is accepted whenever the time required for remanufacture would be deemed "unreasonable." Indeed, the language of several of the opinions implies this distinction.

It will be recalled in this connection that the old form of the New York policy limits recovery to what it would *then* cost to replace and

[81] Under another form of policy, however, the Michigan Supreme Court has also limited recovery to manufacturing costs. Chippewa Lumber Co. v. Insurance Co., 80 Mich. 16, 44 N.W. 1055 (1890). Here, however, the policy read:

"The cash value of the property . . . shall in no case exceed what would be the cost to the assured at the time of the fire of replacing the same and in the event of any claim . . . *of any manufacturing establishment, the measure of damage shall in no case exceed the actual cost of producing the same.*" (Italics ours.)

In another case under the more usual form of standard policy, the same court held that market value rather than manufacturer's costs might be recovered, and it distinguished the standard type of policy from the one that was involved in the Chippewa Lumber case. Mitchell v. Insurance Co., 92 Mich. 594, 52 N.W. 1017 (1892).

[82] Hartford Fire Ins. Co. v. Cannon, 19 Tex. Civ. App. 305, 46 S.W. 851 (1898); Va. Fire Ins. Co. v. Cannon, 18 Tex. Civ. App. 588, 47 S.W. 945 (1898); Mitchell v. Ins. Co., *supra* note 81; Frick v. United Firemen's Ins. Co., 218 Pa. 409, 67 Atl. 743 (1907); Phillips v. Home Ins. Co., 128 App. Div. 528, 112 N.Y. Supp. 769 (1st Dept., 1908); Mechanics Ins. Co. v. Hoover Distilling Co., 182 Fed. 590 (C.C.A. 8th, 1910); Fisher v. Crescent Ins. Co., 33 Fed. 544 (C.C.W.D.N.C., 1887); Globe & Rutgers Ins. Co. v. Prairie Oil & Gas Co., 248 Fed. 452 (C.C.A. 2d, 1917).

[83] It is impossible to ascertain the exact situation from the opinion. It seems, however, that the sewing machine company had made a contract of sale, retaining title to the machines, and that at the time of the destruction the machines were on the premises of the vendee. For all that appears the company, if required, could have replaced these machines from stock.

[84] *E.g.*, Mitchell v. Ins. Co., *supra* note 81.

that there is nothing about replacement in a "reasonable time." Obviously, however, if the limiting clause is to be deemed of any force whatever, the word "then" must be construed very loosely, since an *immediate* replacement in the strict sense of the word is invariably out of the question. The cases have, therefore, interpreted the phrase "what it would then cost" to mean "what it would cost in a reasonable time." They have not been clear, however, as to just what is the test of "reasonable time." In itself the term is ambiguous. It might be interpreted as such a time as would reasonably be required to remanufacture the property in view of all the circumstances of the case. For example, a reasonable time in which to replace a certain type of building might be 1 year, while a reasonable time in which to produce well-seasoned whiskey might be 5 years. On the other hand, the term "reasonable" may conceivably refer to the question whether the time necessarily required for remanufacture is so embarrassingly long that the owner of the property could not fairly be expected to wait until he could replace the goods in this way. According to this interpretation, a manufacturer of seasonal products who could remanufacture his goods only after the season had closed might argue that selling price rather than cost of manufacture should govern his recovery on the ground that he could not manufacture in a "reasonable time." This second interpretation seems to have been accepted by the courts, at least in the case of goods in the hands of manufacturers.

In *Texas Moline Plow Co. v. Niagara Fire Insurance Co.*,[85] the insured company, which was a wholesale dealer, claimed that the destroyed machines should be valued at the amount for which they could be sold to dealers, since it was impossible to make an immediate replacement at the time of the fire. The insurer, on the other hand, claimed that the limiting clause of the type of the old New York policy applied and pointed out that the insured did, as a matter of fact, replace the machines within 30 days after the fire. The court held for the defendant insurance company. "What it would 'then' cost to replace did not mean what it would cost to replace *instanter*, but rather what it would cost to replace within a 'reasonable time.'" For some unstated reason the court apparently felt that 30 days in this case constituted a reasonable time.

There are other cases in which a court has refused to apply the limiting clause on the ground that replacement within a reasonable time was impossible. In *Phillips v. Home Insurance Co.*,[86] straw hats which had been finished, sold, and cased for shipment were destroyed

[85] *Supra* note 28.
[86] *Supra* note 82.

while in the hands of the manufacturer. The ordinary time for remanufacture of the hats was found to be 4 months, but in this case the insured's factory was destroyed and it would take a considerable time to reconstruct. No other factory could be secured for making the hats, nor could they even be purchased on the market. In view of this state of facts the court remarked:

> There would be no difficulty in deciding the question and doubtless no controversy except for the clause of the contract providing that the loss ro damage "shall in no event exceed what it would then cost the insured to repair or replace the same with material of like kind and quality." Without this clause the actual cash value must be conceded to be the measure of damage. Whatever may be the rule with respect to ordinary manufactured articles, and whether under ordinary circumstances the cost of manufacture under this clause would be the measure of loss, we are of opinion, under the facts as stipulated, that the plaintiff is entitled to the actual cash value and is not limited to the cost of manufacture. . . . Under the facts as stipulated it is impossible to apply the clause respecting repair or replacement. The plaintiff could neither buy them nor could he manufacture them in time to be of any value. There is no other mode, therefore, under the contract of ascertaining the plaintiff's loss except by taking the actual cash value which is conceded to be the price at which they were contracted to be sold.

In *Mitchell v. St. Paul German Fire Insurance Co.*,[87] lumber had been destroyed in the hands of a millowner. The owner possessed a large tract of timber from which lumber of like kind and quality could be manufactured, and the defendant insurance company argued that, by virtue of the limiting clause, recovery should be limited to what it would cost the plaintiff to replace the burned lumber by cutting from his own land and by the use of his own mill. The defendant further argued that the word "then" in the policy did not call for immediate replacement, since that would not be possible even by purchase in the open market. In finding for the plaintiff the court pointed out that a tremendous quantity of lumber had been destroyed, namely 16,000,000 feet, and that it might take from 6 months to a year to replace it by the method suggested by the defendant. The court accordingly held that the insured might recover "market value" in the sense of the current selling price of the lumber and that the limiting clause did not here apply. Just why the court felt that a period of from 6 months to 1 year was too long to be "reasonable" does not appear from the opinion, since the facts did not make it clear whether the millowner still had in his yards enough unburned lumber to supply all the requirements of his sales up to the time when

[87] *Supra* note 81.

he might have replaced the destroyed lumber by remanufacture. The language of the opinion suggests that, to this particular court, cost of replacement in the market rather than cost of manufacture is the invariable rule, to be applied regardless of the question whether or not remanufacture could take place in a "reasonable time."

> We are unable to agree with the learned counsel for the defendant that the contract is to be construed any differently in this case than though the plaintiffs had no stumpage of their own, and no mill by which they could manufacture lumber. It means that the plaintiffs had the right on the date of the fire to recover from the defendant such an amount of money as it would cost them to replace the lumber, or in other words, the market value of the lumber at the date of the fire.

If the decision is fairly to be construed as broadly as this language suggests, it would seem to be out of line with the general run of the cases.

With respect to whiskey destroyed in the hands of a distiller, it has been held that if this whiskey was aged the manufacturer may recover its market value, that is, its current selling price, and is not compelled by the limiting clause to receive merely the cost of manufacturing raw whiskey.[88] This holding is defended on the ground that the replacement of aged whiskey with new whiskey does not constitute a replacement with "like kind and quality." It has also been held that, where oil has been destroyed in the hands of a producer, its market value rather than the cost of procuring it from the producer's wells is the correct test despite the limiting clause.[89] Of course the allowance of the mere cost of securing the oil from the wells would result in gross underindemnity unless an adequate allowance were made for the depletion of the well in computing replacement cost; and the practical difficulty of estimating the replacement cost with any such allowance may well explain the refusal of the court to look at anything but market price.

The cases that have been cited have arisen entirely under the *old* New York standard policy. Whether or not the changes that have already been noted in the phrasing of the newer New York policy will in any way affect the decisions can only be surmised, as no cases under the newer clause have been reported at the date of writing. One possible change has been suggested by virtue of the omission in the newer policy of the italicized words in the phrase "what it would cost *the insured* to replace." It has been suggested that this change is designed

[88] Mechanics Ins. Co. v. Hoover, *supra* note 82; Frick v. United Firemen's Fund Ins. Co., *ibid.*

[89] Globe & Rutgers Ins. Co. v. Prairie Oil & Gas Co., *supra* note 82.

to make the cost of replacing *in the market*, as distinct from manufacturing cost, the test where the goods are held by a manufacturer.[90] Without being confident on this issue, the writers are inclined to risk the opposite prophecy and to guess that the newer policy will be interpreted in this respect in precisely the same way as was the old one.

The second change which has been noted in the new limiting clause is that under the former clause the test is what it would *then* cost to replace, whereas under the newer clause the test is what it would cost to replace *within a reasonable time.* In view of the fact that even under the older form, "what it would then cost to replace" has been judicially interpreted to mean what it would cost to replace "in a reasonable time," there seems to be no good ground for reading any significance into this change.

The cases involving the interpretation of the limiting clause as cited above have been confined entirely to personal property. Conceivably the clause might also have significance with respect to buildings, for it might operate to prevent a recovery in excess of replacement cost, even in a case where the "market value" of the building (measured by the difference between the market value of the entire property and the market value of the vacant land) could be proved to exceed replacement cost. Under ordinary conditions it may be assumed that no such excess would in fact be found; but there may be cases where it could be proved to exist owing to an unusual demand for buildings for immediate occupancy. Presumably, in a case of this kind the limiting clause would apply, but we have not discovered any reported cases that present this issue. The fact that nearly all the litigated cases have involved the valuation of old buildings, the market value of which, however interpreted, could not exceed replacement cost new, has evidently prevented the limiting clause from being an important factor in building-valuation cases.

Summary.

The conclusions that have been reached in this study of insurance cases may now be summarized briefly. The summary is given, however, with a warning that the reported cases in this field are

[90] "As a matter of substance the omission of the words, 'the insured,' renders it unnecessary in the future to consider the relation of the insured to the cost of repair or replacement. Hereafter the subject will be treated upon an absolute rather than a relative basis. If the insured is in such a position as to be able to repair or replace at less than market cost that circumstance would not necessarily be available to the company to decrease its liability in so far as it may be measured by the replacement cost. . . . Cost of repair or replacement should be treated on the basis of general market conditions rather than its relation to any particular

meager and that the generalizations lack the force that they would have if based on a larger number of precedents.

1. According to the terms of most of the policies, including the three most popular standard types, "cash value" at the time of the fire is stated as the measure of recovery, subject, however, to the limiting clause in the policies of the old and the new New York type. The Massachusetts form of policy is content with the mere phrase "cash value," whereas the old New York policy adds, "cash value with proper deductions for depreciation however caused" and the new New York policy reads, "actual cash value (ascertained with proper deductions for depreciation) of the property at the time of the loss or the damage." No cases have been found, however, which clearly point to any distinction in the interpretation of these three statutory provisions as to the meaning of value.

2. In some of their opinions courts have stated that the proper criterion of cash value is the "market value" or the "fair market value" of the property, whereas in other opinions they have simply repeated the phrasing of the policy to the effect that the measure of recovery is "cash value." At times they have used some colorless and ambiguous term such as "actual value" or "intrinsic value," and on occasion they have accepted the more significant term "value to the owner." These phrases taken in themselves are of almost no use whatever in a study of the real standards that are accepted by the courts.

3. In all but a small fraction of the cases, cost of replacement, with allowances for depreciation, has been accepted either as the measure of loss or else as the dominant evidence of this loss. This statement holds good despite the fact that in most cases the courts do not directly state that replacement cost is the test, but instead indicate that "market value" or "actual cash value" is the criterion. Their choice of the pertinent market, however, as well as their rulings on admissible evidence, indicates a strong tendency to choose such a "market value" or such a "cash value" as would make possible the replacement of the property at prices prevailing at the time of the fire minus deductions for depreciation. Thus where goods are destroyed in the hands of a wholesaler, the "market value" which is chosen as the basis of recovery is the current selling price by manufacturers to wholesalers rather than the current selling price of wholesalers to retailers. Similarly, if the same goods are destroyed in the hands of a retailer, current wholesale price will be accepted rather than retail price, and if the goods are in

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party, and it was with this view that the change from the old form was made." *The Standard Fire Insurance Contract* (1922), p. 45.

the hands of the ultimate consumer, retail price will be used with allowances for depreciation.

4. Although cost of replacement rather than selling price is generally accepted as the measure of value where goods are destroyed in the hands of a dealer, it may be questioned whether the insured might not recover selling price if he could prove beyond reasonable doubt that he was unable to replace the destroyed goods in time to avoid missing his market. We have found no reported cases on this point, although the case of the destruction of straw hats in the hands of the manufacturer, where the manufacturer was allowed to recover his selling price despite a provision in the policy limiting recovery to replacement cost, suggests by analogy that a court might allow a dealer to recover his selling price where he could prove that he was unable to replace the property in time to avoid a loss of profits.

5. Although the price for which the property can be replaced rather than the price for which it can be sold is the more generally accepted standard, it is not clear to what extent the peculiar ability of the particular owner of the property to replace at less than the normal market price might reduce the amount of his recovery under a policy making cash value the measure of loss. Query, for example, whether the cash value of property in the hands of a consumer would be limited to wholesale price in a case where the consumer himself, by virtue of some special and unusual arrangement, was proved to be able to replace at the wholesale price. In the absence of cases it is surmised that this situation would be disregarded as being one of those unusual situations which should not influence the recovery and that the consumer would be able to recover retail price on the ground that the retail market is the *normal* mode of replacement for an owner of that class.

6. Although replacement cost in the normal manner seems to be the general rule with respect to goods destroyed in the hands of a dealer or user, there is an apparent exception in the case of manufactured goods destroyed in the hands of the manufacturer. Here the general rule seems to be that cash value is measured by the current prices at which manufacturers sell similar goods rather than by the estimated cost of manufacture. This rule may be attributed partly to the fact that a court will generally prefer some sort of a market price to an estimate of manufacturing costs in view of the difficulty of proving the latter, and partly to the fact that in the majority of cases it may be assumed that a manufacturer would lose his opportunity to profit by the sale of the property if he were obliged to wait for time to elapse in which to remanufacture the destroyed goods.

7. Where it is necessary to find the cash value of used personal property in the hands of a consumer, a question sometimes arises as to whether the value should be measured by cost of replacement new minus a deduction for depreciation or by cost of replacement in a secondhand market with property of similar age and in a similar condition of wear and tear. The choice between these two tests seems to depend on the question whether the owner of the property might normally be expected to replace with a new article or with a secondhand article. With respect to personal effects, for example, the purchase price of similar goods in a secondhand market has been held to be inadmissible as evidence of value on the ground that the owner would not normally replace in this manner. On the other hand, with respect to property of a less personal nature, such as cars and locomotives, the market price of similar used equipment, if such a market could be shown to exist, would doubtless be admitted in evidence.

8. Where replacement cost new is offered as evidence of the value of the property, allowance must be made for *physical* depreciation at least, and where the destroyed property is used property the mere submission of evidence as to replacement cost new, unaccompanied by evidence of wear and tear, will not be sufficient for a jury. As to the basis of computing physical depreciation, however, the opinions of the courts say almost nothing. In general, the question of the amount of depreciation is submitted to the jury on the basis either of testimony as to the age and general physical condition or else of opinion testimony by competent witnesses as to the extent of the depreciation.

9. Although there are dicta in some building-appraisal cases which might possibly be construed as measuring cash value by replacement cost minus mere physical depreciation, the decided weight of authority is to the contrary, and courts show an increasing tendency to admit all relevant evidence which would indicate that by virtue of obsolescence or inadaptability or any other circumstances the value of the property to the owner is less than its replacement cost minus physical depreciation. Examples of the readiness of the courts to take into account other abatements from replacement cost new than mere physical depreciation are: first, the case of the molds and patterns in the hands of a manufacturer which were to be valued on the basis of their probable future use, bearing in mind their obsolescence; second, the case of commercial buildings where it has been held that evidence of gross and net rentals is admissible in proving the fair cash value of the building despite the contention of one of the litigants that nothing but replacement cost minus depreciation for age should be considered; third, the holding of the New York Court of Appeals in the recent

McAnarney case that the valuation of brewery buildings which had been destroyed subsequent to the passage of the National Prohibition Act should be made with reference to the fact that the buildings were no longer available for the profitable production of malt.

10. Although most courts have held that the term "depreciation" should be construed in a broad sense and should not be limited to physical depreciation, they have refused to take into account a depreciation in mere *market* value where this fall has not affected the value of the property to the owner. In the case of buildings, for example, the courts have held that the "market value" of the building (that is, the price for which the old property could be sold minus the price for which the land alone could be sold) is not the criterion of cash value as a measure of recovery for fire-insurance loss. Similarly, with respect to used automobiles in the hands of their owners it has been held that the price for which the owner could have resold the car does not limit recovery.

11. Although the courts have in general been willing to take into account all circumstances tending to show that the value of property to its owner is less than its replacement cost minus physical depreciation, they have made a distinct exception to this rule in the case where an owner of real estate has contracted to sell his property to a purchaser under an agreement that he will remove the building or under an option permitting him to remove the building subject to its forfeiture to the new purchaser. In these cases, although it is clear that the value of the building to its owner must be only a fraction of its normal value, the courts have nevertheless held that what they have called the "intrinsic value" of the building shall govern the recovery and not the much lower sum which the peculiar facts of the case would warrant on the principle of indemnity. In the opinion of the present writers, these cases are distinctly unfortunate, for they are an obvious violation of the principle of indemnity and offer a maximum temptation to incendiarism.

12. Unlike the Massachusetts type of policy, the old and the new New York standard policies insert a clause limiting recovery to cost of replacement even though this sum is less than what would otherwise be termed the cash value of the property. In view of the distinct tendency of the courts, however, to measure cash value itself by replacement cost (with allowances for depreciation) this clause seems to have very little significance except in one type of case, namely, a case involving the recovery for manufactured goods destroyed while in the hands of the manufacturer. In this case it would seem that the limiting clause may limit recovery to manufacturing cost despite the hold-

ing that "cash value" in itself means "selling price," provided that the court finds that the owner, in view of all the circumstances, might have manufactured the goods in a "reasonable time."

In general we conclude that the opinions of the courts, especially of the appellate courts, have shown an increasing desire to make the measure of recovery for fire-insurance losses correspond to the actual loss sustained by the insured in view of all the circumstances of the case. To put the matter in other words, the courts, when faced with a choice between applying some standardized rigid test, such as replacement cost minus physical depreciation, or of adopting some more flexible test which can be modified in such a way as to accord more nearly with the principle of indemnity, have generally preferred the latter alternative even though it has involved the sacrifice of administrative convenience and of simplicity. This statement is made without any intent to deny that the actual results of litigated cases will often depart far from the principle of indemnity. There is no reason, for example, to doubt the strong conviction among fire-insurance adjusters that in the main the values found by juries and accepted by courts for old and obsolete buildings tend greatly to exceed the commercial value of the buildings. This tendency, indeed, explains the well-accepted canon of fire-insurance practice to the effect that an old building is a bad risk. In the main, however, the tendency may be said to prevail *despite* the accepted legal rules rather than *because* of them, and it is to be explained, partly on the ground that juries have a natural and human tendency to be favorable to an insured individual as against a large and wealthy insurance company, and partly on the ground that the degree of obsolescence of an old building is so difficult to measure that it is likely to be underestimated.

So far as concerns the accepted legal theory, as distinguished from the actual results of jury awards, the main cleavage that still prevails as between the measure of damages and the actual injury sustained by the insured lies in the fact that the standard fire-insurance policies exclude recovery for certain losses incidental to the destruction of the property. These losses are designed to be covered by special forms of policies in the nature of profit insurance, use-and-occupancy insurance, rental insurance, and rental-value insurance policies. The cash value of a property is, therefore, not regarded as synonymous with the amount of pecuniary loss which its destruction imposes upon its owner. As a rule the upper limit of cash value is replacement cost, although occasionally the alternative limit of selling price has been adopted.

CHAPTER XVI

VALUATION UNDER THE LAW OF EMINENT DOMAIN

Except for public-utility rate making, eminent domain furnishes perhaps the richest single field for the study of legal valuations. The reported opinions are numerous, and they show no leniency toward such crude, wholesale appraisals as are upheld in the property-tax cases. They illustrate, even more clearly than the damage cases, the attempts of the courts to reconcile their doctrine of indemnity with their inconsistent doctrine requiring a valuation at "market value." They reveal the difficulties which the law meets in conceiving property sometimes as a tangible thing, to be valued as a thing, sometimes as a group of rights to be valued with respect to each individual who possesses those rights. They present a triangular distinction between three possible values, market value, value to the owner, and value to the taker, and raise questions as to how the one value may affect the others. They suggest a queer paradox in the fact that, while legal doctrine limits the owner to a recovery only for his more direct damages, many, perhaps most, awards actually result in overindemnity for *all* losses. Finally, they offer an opportunity to compare the valuations placed by a court on a public-utility plant for rate-making purposes with the valuations applied to the same type of property under the law of condemnation.

Because appraisal under the law of eminent domain is so rich in case law, we have made it the subject of a special treatise, written by Lewis Orgel in collaboration with the present writer.[1] This companion book makes it unnecessary to present here more than a summary containing few case references. Supported by the detailed study, this summary may venture broad generalizations that would otherwise be dangerous.

[1] Orgel, *Valuation Under the Law of Eminent Domain* (Charlottesville, Va., 1936). See also the standard American treatises: Philip Nichols, *The Law of Eminent Domain* (2 vols., Albany, N.Y., 1917); John Lewis, *A Treatise on the Law of Eminent Domain in the United States* (3d ed., 2 vols., Chicago, 1909). Charles T. McCormick's excellent *Handbook on the Law of Damages* (St. Paul, 1935), includes a long chapter on condemnation.

The Economic Function of the Power of Eminent Domain.

The principles by which property is valued under the law of eminent domain can be understood only in the light of the purpose that this extraordinary power is assumed to serve. Under any legal-economic system known as one of "private property" or "capitalism," the ordinary mode of acquisition of property rights is through what is called a "voluntary" purchase, in which the buyer and seller agree upon a transfer at a given price. This price is arrived at by the procedure of bargaining and is determined by the familiar forces of competition. Even the sovereign governments, or the public-utility companies that are treated in some respects as agents of the governments, acquire by far the major part of their property rights in this way.

But it has long been recognized that certain types of property essential to the needs of government or of a public utility cannot always be acquired at a fair price except by expropriation rather than by a voluntary transaction. Real estate, particularly though not exclusively, belongs in this category. What a state or city needs when it constructs a public road, and what a railway needs when it lays a track, is a group or line of particular tracts of land, not merely any land of a given quality. Unarmed with the power of eminent domain, efforts to secure these tracts at a reasonable price would almost certainly be frustrated by owners who would willfully refuse to sell at any price, or who would demand a "holdup" price.

Accordingly, political tradition and constitutional law sanction the expropriation of private property for public purposes on payment by the taker of "just compensation." There has developed an elaborate body of law as to the meaning of "just compensation" and as to the technique and procedure by which it shall be measured in any given case. A problem of valuation arises here, because, for the most part, that compensation is deemed to be "just" which represents the "value" of the condemned property at the time of the taking.

Just Compensation Identified with Indemnity.

The long-established practice in foreign countries, of coupling the power to expropriate property with the obligation to compensate the owner, is embodied by language in our Federal Constitution. The Fifth Amendment, which contains the famous phrase, "nor shall private property be taken for public use, without just compensation," applies only to the Federal government; but the Fourteenth Amendment, which extends the "due-process-of-law" clause of the Fifth Amendment to the states, has been judicially construed to include the

obligation to pay just compensation.[2] Nowhere in the Constitution, however, is there any definition of "just compensation"; and its identification both with the principle of indemnity and with an award based on the "fair value" of the property is purely a matter of judicial interpretation or lawmaking.

To be sure, the very term "just compensation" suggests the idea of indemnity, for "compensation" and "indemnification" are often used as perfect synonyms. Thus lawyers speak of "compensatory damages" to distinguish them from penal damages or from awards based on the doctrine of unjust enrichment. But not always is "compensation" given this restricted meaning; sometimes it is a mere substitute for the word "payment." Broadly used, "just compensation" might therefore mean nothing more than "just payment" and might be taken to require an award to the owner for the value of the condemned property to the taker, and not merely for its perhaps much lower value to the owner himself.[3]

But as a matter of doctrine, though by no means always as a matter of practice, the higher courts in this country have construed "compensation" in its stricter sense and have held that "just compensation" means indemnity to the owner for the loss of his property. This is the import of the many rulings, to be discussed later, that "value to the taker" is not the measure of the award, and of Justice Holmes' classic remark that "the question is what has the owner lost, not what has the taker gained."[4]

Traditional economic theory gives much support for this prevailing legal doctrine under which the award is limited to indemnity for loss imposed upon the owner. That is to say, it furnishes a defense for the holding that owners of condemned property should not be permitted to *profit* by the taking, even if one concedes the social wisdom of permitting property owners to make profits in ordinary, voluntary sales. In orthodox economics, the only intelligent excuse for the profit system is, not that it results in a "fair" distribution of wealth—for no sane modern economist could maintain that absurd thesis—but rather that profits furnish the incentive necessary to get the work of the world accomplished. If a grocer cannot hope to derive a positive benefit

[2] Chicago, Burlington & Quincy R.R. v. Chicago, 166 U.S. 226 (1897), and cases cited by Orgel, *op. cit.*, Chap. 1, n. 4.

[3] Compare, for example, actions of assumpsit for *quantum meruit* or *quantum valebat*, where the compensation for the value of services or commodities sold without an express agreement as to price, is not made to depend entirely on the loss suffered by the seller in rendering the service or in transferring the commodity.

[4] Boston Chamber of Commerce v. Boston, 217 U.S. 189 at 195 (1910).

from a sale of a bunch of bananas, and not merely to be saved from loss by making this sale, he will not supply the community with bananas. If a real-estate operator knows that he will not be permitted to sell his real estate for more than an amount necessary to indemnify him for his outlay, he will not promote and develop real estate. And so on throughout the entire realm of business transactions. But the power to condemn property by eminent domain is exercised sporadically, not regularly, so that property owners cannot generally count on the opportunity to have their property condemned as an inducement to them to develop this property for the uses for which it is needed by the condemner. To be sure, real-estate speculators often purchase properties shortly in advance of condemnation, on receipt of a rumor or of inside information that these properties will be taken; and the fact that this practice is so generally profitable proves that the courts have been unwilling or unable to put their doctrine of mere indemnity into effect. But profit-making opportunities of this sort are not the kind of opportunities that can be adduced in favor of the profit system. There is no incentive here to adapt the property to the needs of the condemner. On the contrary, the incentive is to start useless work on the land with the object of increasing the award.

Distinction between a "Taking" of Property and a Damage.

Despite what has just been said, any attempt to explain the rules of compensation as *mere* corollaries of the basic principle of indemnity is frustrated by the presence of a conflicting legal principle distinguishing between recoverable and nonrecoverable losses. Under the United States Constitution and many of the state constitutions, compensation need be paid only for the "taking" of "property" and for certain restricted types of damage mentioned in a later section on the "partial-taking" cases. Even under those state constitutions that require payment for property that is "taken or *damaged*" for a public use, the courts have not greatly extended the list of recoverable injuries. In view of these restrictions, it is not enough for a property owner, seeking compensation under the law of eminent domain, to prove the amount of monetary loss that he has sustained by virtue of an act of government or of an agency of the government. With certain exceptions, the owner must also establish the fact that this loss constituted a "taking" of his "property."

For our purposes it is unnecessary to discuss the various tests by which the courts have distinguished between "takings of property" and other pecuniary injuries.[5] Occasionally the word "property"

[5] See Orgel, *op. cit.*, Chap. 1, §3; Nichols, *op. cit.*, Chaps. 7 and 8; McCormick, *op. cit.*, Chap. 21.

has been narrowly construed, so as to justify rulings denying recovery for losses of good will and of other valuable interests that, in other fields of modern law, have been given the dignity of a "property right." More frequently, emphasis has been placed on the difference between a "taking" of "property" by the condemner for its own benefit, and a mere incidental injury to, or even complete destruction of, property. Often the seriousness of the injury rather than its technical nature seems to have been the determining factor: if the damage is large it may be held to constitute a "taking"; if it is minor, it may be brushed aside as an "incidental" loss.

But whatever may be the real reasons, or the judicial apologetics, for the distinction between a "taking" and a mere "damaging," the fact that it is made often has a decided bearing on the principles of valuation accepted by the courts. It partly explains the usual rule, to be discussed later, limiting recovery to the "market value" of the condemned property, even when this property was worth to its owner much more than market value. And it largely accounts for the distinction, drawn by the courts in most real-estate condemnations though much less sharply drawn in utility condemnations, between the value of real property that is taken, and the value of the *business* located on the premises. Most courts have held that no compensation need be paid for incidental injuries to the business, such as those due to loss of good will or to the costs and annoyances of a relocation in new premises.[6]

Value of the Property as the Measure of Compensation.

The rôle of valuation under the law of eminent domain is set by the doctrine, universally accepted by American courts, that just compensation for condemned property includes a money payment equal to the value of the property at the time of the taking.[7] On occasion, to be sure, owners are entitled to additional awards for certain damages to property not deemed to have been taken, as well as for interest accruing between the time of the taking and the time of payment. But the value of that property which is expropriated sets the minimum award and, perhaps more often than not, fixes the major part of the total payment. We are brought, therefore, to the question of the meaning which the courts attach to the phrase "value of the property," and to the technical rules by which they determine this value or guide its determination by a jury.

[6] Banner Milling Co. v. State, 240 N.Y. 533, 148 N.E. 668 (1925), and cases cited by Orgel, *op. cit.* Chap. 5, and by Nichols, *op. cit.*, Chap. 8.

[7] Monongahela Navigation Co. v. U.S., 148 U.S. 312 (1893), and cases cited by Orgel, *op. cit.*, Chap. 2.

What construction have the courts placed on these ambiguous terms? The question may best be answered by separate consideration of the more important ambiguities.

a. Market Value Must Necessarily be Given a Hypothetical Meaning.

The first point to note is one that has seldom been clearly expressed in the cases, although its implications have been recognized. When the "market value of the property at the time of the taking" is the accepted measure of compensation, value in a hypothetical market, and not actual market value, must necessarily be accepted in order to avoid circuity of reasoning. At the time of the taking, which corresponds roughly, at least, to the time when the owner is deprived of the beneficial use of the property, the condemned property is literally valueless, both to the owner and to any prospective private owner, except for the fact that its ownership confers a claim to a money compensation from the condemner. If a residence property must be vacated today by its private owner, because on this date possession is taken by the city or by a public-utility company, it is really no longer a residence property, but a mere opportunity to compel the condemner to make a cash payment at some future date. Only for this latter purpose is it salable on the market place. Even for a considerable time before this date, its actual market value is based entirely, or almost entirely, on the price at which the claim to a cash award can be sold to some speculative buyer.

But were market value defined in the accurate sense just indicated, it would clearly be disqualified as a measure of fair compensation. Necessarily, therefore, the courts cannot mean literally what they say when they announce "the market value of the property at the time of the taking" as the proper measure of compensation. A hypothetical market value must be assumed, one that is identified with the price

Good

at which the property *would* have sold on the fictitious assumption that condemnation was not contemplated.

This necessity of estimating a hypothetical market value for condemned properties has sometimes given rise to practical difficulties; for it has compelled the tribunal to discount or ignore the prices at which the particular property, or adjacent condemned lands, have actually been sold in contemplation of the taking.[15] Various solutions

[15] See, for example, Olson v. U.S., 292 U.S. 246 (1934), where the Supreme Court held that the "fair market value" of land condemned for reservoir purposes was properly measured without recognition of the high prices at which certain of the tracts had actually been sold prior to the taking but in contemplation of the receipt of a high award.

It is possible that state might itself be in hand much higher value for adjacent lands on "voluntary sale basis".

of the difficulty have been resorted to at times.[16] Recent sales of neighboring tracts of *uncondemned* land have been introduced as evidence of what *should* be called the hypothetical market value of the instant land. Earlier sales of the condemned land, made before condemnation was imminent, have been taken as evidence of present values. Rental values of the property in question have been estimated by expert witnesses, and the capital values of the condemned real estate have been estimated by a capitalization of these actual or estimated rentals. But in some cases, particularly where large tracts of land have been taken under a system of public works that has long been in contemplation, the difficulty of discounting the influence of the proposed condemnation on the market prices of the land has been insurmountable. This was true, for example, in the condemnation of land for the great Ashokan reservoir,[17] which supplies New York City with water. Long before the time of the taking, tracts available for reservoir purposes had been transferred to speculators at prices which anticipated overgenerous awards. Inability to determine to what extent these prices were thus inflated led the courts to admit them as evidence of value and presumably led to awards based on the very expectations of excessive awards.[18] Alert and conscientious condemners are well aware of this situation and do their best to minimize its evil by refraining as long as possible from disclosing the precise location of the land that is to be bought or condemned for a public use.[19]

b. Does Market Value Exclude Consideration of Special Value to the Owner?

Of much importance in the law of eminent domain is the distinction, stressed at length in Chaps. III and IV, between sale value and value to the owner. Real property belongs in that class of wealth which is often worth more to a given owner than to any prospective purchaser. This is true because, instead of being standardized like wheat, or government bonds, or tubes of shaving cream, improved real estate may be specially constructed for, or adapted to, the peculiar needs of its occupants. If the United States Steel Corporation were to be reimbursed for its Gary plant at the mere price at which this company could sell it

[16] See Orgel, *op. cit.*, Chap. 8.

[17] See Matter of Simmons, 58 Misc. 581, 109 N.Y. Supp. 1036 (1908).

[18] See Matter of Gilroy, 85 Hun 424, 32 N.Y. Supp. 891 (1895); *cf.* Matter of Simmons, *op. cit.*

[19] But the difficulties of this practice are almost insuperable. See *Report on Law and Procedure in Condemnation Applicable to Proceedings Brought by the City of New York*, by Leonard M. Wallstein, Special Assistant Corporation Counsel of the City of New York (New York, 1932), pp. 326, 370.

to some rival enterprise, or if the owner-occupant of a house and lot were to be forced to vacate it on payment of nothing more than the price at which he could market it, gross underindemnity might well result. Yet, if market value is accurately construed, only sale price can properly be allowed. On the other hand, if it is so construed as to include the special value of the property to the owner, it becomes an unfortunate synonym for this latter standard of value.

In later chapters we discuss this same problem as it arises in assessments under the general property tax and under other taxes. Neither in taxation nor in eminent domain has the issue been faced in a clear-cut manner by most courts; and the opinions that are explicit are in conflict. In eminent domain, some courts recognize situations, to be mentioned in the next section, where value to the owner rather than market value is the proper basis of compensation. But even in the usual situation, where market value is held to be the objective, it is by no means clear that the courts always desire to exclude consideration of the worth of the property to the owner himself.

There are statements in some of the opinions which, taken literally, would limit compensation to the price at which the owner might have sold his property. Thus, said one court, the owner is "entitled to receive just such an amount as he could obtain if he were to go upon the market and offer the property for sale."[20] The only *universally* recognized qualification of this assertion is the ruling against forced-sale values. As stated in the same case,

> And when we say that the owner is entitled to receive the price for which he could sell the property, we do not mean the price he would realize at a forced sale upon short notice, but the price that he could obtain after rea on-able and ample time such as would ordinarily be taken by an owner to make sale of like property.[21]

But many other opinions, instead of defining market value in terms of a sale that might actually have been negotiated in a reasonable time, resort to the jargon of the "willing buyer" and "willing seller" and thereby leave room for an inference that the market may be assumed, contrary to the facts, to include one or more "willing buyers" whose needs for the property correspond to the peculiar needs that are actually felt only by the present owner himself. This inference was clearly drawn in one case involving the condemnation of a tract of land that was available for the expansion of the owner's adjacent factory and that was therefore apparently worth much more to that owner than to

[20] L. R. Junction Ry. v. Woodruff, 49 Ark. 381 at 390, 5 S.W. 792 at 794 (1887).
[21] *Ibid.*

anyone else.[22] Although holding that market value was the proper measure of compensation, the court encouraged the assumption of a nonexistent willing buyer who would want the tract for industrial purposes. By way of analogy it said, "Of course the market value of a church could not be determined by saying just what somebody would give for that piece of property, because the ordinary citizen does not want to own a church, but what would a congregation that desired a church give for the church." Thus, while verbally adhering to the rule of market value, the court actually suggested a measure of compensation not clearly distinguishable from special value to the owner.

Few other judicial statements in the cases are as explicit on this point as is the one just quoted. Most of them stop with some version of the "willing buyer, willing seller" incantation, leaving the jury and the expert witnesses uninstructed as to whether they should invent a fictitious willing buyer who differs from flesh-and-blood buyers by having the same needs and desires as does the owner.

c. *Is Market Value Measured by Current Market Price Even in an "Abnormal" Market?*

The fact that, under the law of eminent domain, the courts set some specific date, called "the time of the taking," as of which market value must be determined would seem to imply that the appraisal should be based strictly on market conditions prevailing on that day, however abnormal they may have been. Forced-sale values, to be sure, have invariably been held inapplicable; but these holdings are often taken merely to require the assumption of due time on the part of an owner for the negotiation of a favorable sale. They do not necessarily imply that sales in a depressed market are to be excluded.

Prior to the business depression of 1929, the courts adhered fairly strictly to the theory just stated. It was repeatedly held that increases or decreases in market value between the date of the taking and the time of the trial should not be taken into account. Cases involving depressed market conditions were surprisingly meager, and the few that we have found were inconclusive as to the owner's rights to a higher, "normal" market value. But in boom-price markets the owners were awarded boom-price values. Perhaps the most significant holdings of the latter type were those of the United States Supreme Court and the lower Federal courts in the requisition cases under the

[22] Producers' Wood Preserving Co. v. Commissioners of Sewerage, 227 Ky. 159 at 166, 12 S.W. (2d) 292 at 294 (1928).

Lever Act, requiring payment for coal and other products based on the admittedly inflated prices prevailing during the World War.[23]

The pending business depression has raised the question of deflated prices in a critical form, both with respect to tax assessments, where the property owners desire a low valuation, and with respect to eminent domain, where they desire a high valuation. In the latter field only two or three reported opinions have yet come to our attention, and these show a conflict of authority.

The view that, even during a severe business depression, the owner of condemned property should be limited to a recovery of prevailing market price, is represented by an opinion of the highest Connecticut court in *Alishausky v. MacDonald.*[24] We quote at length from this opinion, since it presents a persuasive argument against a higher award on grounds of fairness and not merely on grounds of doctrinal law:

> It [the owner's contention] was to the effect that the fair market value of the land could not be determined by the value in a "time of temporary economic depression and stringency of the money market, but must be taken as of a time preceding the depression." As the motion lays no basis for any consideration of a temporary financial depression other than the general conditions through which we are passing, we must assume that the claim of the plaintiff referred to these conditions. Aside from the impracticability of applying the rule of valuation suggested, it would be manifestly unsound. The purpose of an appraisal of damages in condemnation is to give to the landowner an equivalent in value of the land taken measured in money. In a time of general depression the money so received will purchase much more than in normal times; if, for instance, the plaintiff desired to purchase other land in place of that taken he could buy a much more desirable property for the same money in a time of general depression than he could when values were at a higher level. The fair market value at the time of the taking is the true rule of valuation . . . and that prices are generally depressed at the time affords no sufficient reason for departing from that rule.

Opposed to this position is the decision of the South Carolina court in *Howell v. State Highway Department.*[25] In that case, the trial judge had charged the jury that

> . . . the actual value of the land means the fair market value of the land, upon a fair market, upon fair advertisement, and a fair sale at normal times. It does not mean any value in times of great inflation in currency nor does it mean the value in times of great depression. The actual value of the land means a fair market value, a fair market in normal times.

[23] U.S. v. New River Collieries Co., 276 Fed. 690 (1921), *aff'd*, 262 U.S. 341 (1923); other cases cited by Orgel, *op. cit.*, Chap. 2, §25.

[24] 117 Conn. 138, 167 Atl. 96 (1933).

[25] 167 S.C. 217 at 221, 223, 166 S.E. 129 at 130, 131 (1932).

The taker assigned error on the ground that the jury were left to fix the value as of a time they thought to be normal, whereas they should have been instructed that the value must be fixed as of the time of the taking. The appellate court affirmed and said:

> We think the instruction is not open to serious criticism. It would be manifestly unfair to the owner if the taking of the property be during a period of deep depression to fix the value as of that exact date. On the other hand, if the taking be during a period of inflated prices, it would be just as unfair to the condemner to fix the value as of that exact period. We think the Circuit Judge exercised a wise judgment when he defined the market value as that which prevailed in "normal times." We think he meant by that phrase not any special date, but used the words "normal times" as synonymous with "normal conditions."

Value to the Owner or "Real Value" as an Alternative Measure of Just Compensation.[26]

other Test

Even though they have taken great liberties with the concept of market value, the courts have recognized situations where an award based exclusively on this kind of value will not constitute the "just compensation" that is required by the state and Federal constitutions. Under some circumstances they have held that another standard of value must be used. Under other circumstances, they have held that the total compensation must include an allowance for damages to the owner's unexpropriated property in addition to the market value of that property which has been taken. In the present section we shall note the first of these alternatives, leaving for the following section a discussion of a separate allowance for severance damages.

Doctrinal law is very vague as to the types of property, or the circumstances of the case, that may call for a valuation at something other than market value. Highly unmarketable institutional properties, such as schoolhouses, churches, and college campuses, have generally been brought under this exception to the rule of market value. Less frequently, country estates and mansions especially designed to suit the owner's fancies have also been included. Railway terminals and other practically nontransferable business premises are sometimes brought under the "fair-market-value" test, sometimes held subject to a different test.

Several of the cases use a form of words to the effect that if the property in question is held by a court or found by a jury to "have a market value," then this value must be used as the measure of compensation; otherwise some other "measure of value" must be used.

[26] See Orgel, *op. cit.*, Chap. 3.

Taken literally, this statement would seem to imply that if the owner could have sold his property to someone else for any price, even if only for $1, his recovery must be limited to this price. In fact, however, the courts read into the phrase "having a market value" the condition that the sale price must reflect a fair payment for the property for the uses to which it is best adapted. A judge is therefore likely to hold that the property in question "has no market value" if he is convinced that there is a wide and measurable discrepancy between the price which it would have commanded on the market place and its value (devoid of sentimental considerations) to the owner himself.

But even when the market-value criterion is rejected, the courts by no means invariably turn openly to the alternative of special value to the owner. Perhaps more frequently they invoke some completely undefined, mythical concept of "real" or "actual" value—a value supposedly inherent in the property itself without reference to the peculiar relations between the owner and his valued possession.[27] This economic heresy, which pervades the literature on the Continental law of expropriation and taxation (under the heading of "objective value" or "value to everyone") no less than American law (under the heading of "real value" or "intrinsic value"), goes hand in hand with the orthodox doctrine of eminent domain as constituting a proceeding *in rem* rather than a proceeding *in personam*[28]—a doctrine, some of the implications of which have been violated under more modern theories of jurisprudence.[29]

In practice, however, it is doubtful whether the meaningless statement that unmarketable property must be valued at its "real value" results in an award differing materially from that which would follow from the acceptance of the conceptually much sounder standard of value to the owner. For the judges who *talk* with the former term, do much of their *thinking* with the latter concept; and even under a verbal standard of value to the owner, the lack of any satisfactory evidence of this kind of value compels the adoption of extremely crude bases of appraisal. Estimates of current replacement cost minus arbitrary

[27] Compare the application of this notion of value in the field of fire-insurance appraisals, *supra* pp. 21–22, 393–394.

[28] See Nichols, *op. cit.*, Vol. I, Sec. 21. In Monongahela Navigation Co. v. U.S., 148 U.S. 312 at 325–326 (1893), the opinion by Justice Brewer stressed the *impersonal* phrasing of the clause in the Fifth Amendment: "nor shall private property be taken for public use without just compensation."

[29] Especially in Boston Chamber of Commerce v. Boston, 217 U.S. 189 (1910), where the Supreme Court refused to value the entire land "as land" and insisted that the claimants be compensated only for the losses of their separate interests in the property. See *supra* p. 108; Orgel, *op. cit.*, Chap. 9.

deductions for depreciation must often be accepted in default of a better measure.

The vital distinction between the value to the owner of property especially adapted to his needs, and the market value of that same property, has been generally ignored by the Supreme Court. This Court has often talked as if "fair market value" were the universal criterion under the law of eminent domain. Yet, in the very cases in which it has invoked this standard, it has also declared that the objective is fully to indemnify the owner for what *he* has lost; and it has even referred in so many words to "value to the owner" as the proper measure of compensation and as if it were a perfect synonym for "fair market value."[30]

Allowance for Damages in the "Partial-taking" Cases.[31]

A wide discrepancy between sale value and value to the owner appears more often in the so-called partial-taking cases than in those relatively rare cases involving unique types of property. If a railroad runs a right of way through the middle of a farm, or if a municipality condemns a distribution system of a public utility leaving the company with a useless generating plant on its hands, the market value of the condemned portion may by no means reflect the damages done to the integral whole and hence may not reflect the full value to the owner of that part of his entire property which has been taken.

In these situations, the courts have uniformly required the payment of compensation in addition to the market value of the part taken, even when the relevant state constitution follows the Federal Constitution by requiring payment only for a "taking" and not also for a "damaging." But they have restricted their holdings on this point by requiring a *physical* relationship between the part and the larger whole,[32] and by declining to make allowances for certain "consequential" or "incidental" damages to the owner's business[33] or to his merely *functionally* related physical property.

[30] See, for example, Olson v. U.S., 292 U.S. 246 (1934), referring to value to the owner (and *not* to the taker) as the desideratum (at 255–256), yet also stating: "Just compensation includes all elements of value that inhere in the property, but it does not exceed market value fairly determined" (at 255). Note also the implicit identification of the concepts of market value and of value to the owner in the following sentence from U.S. v. Chandler-Dunbar Co., 229 U.S. 53 at 81 (1913): "The owner must be compensated for what is taken from him; but that is done when he is paid its fair market value for all available uses and purposes."

[31] See Orgel, *op. cit.*, Chap. 4.

[32] Sharp v. U.S., 191 U.S. 341 (1903); Orgel, *op. cit.*, Chap. 4; Lewis, *op. cit.*, Vol. II, Sec. 689 *et seq.;* Nichols, *op. cit.*, Vol. II, Sec. 241.

[33] See Orgel, *op. cit.*, Chap. 5.

One court met the problem of allowing damages to remaining property without awarding anything more than "value of the property taken," by using "value" in the sense of value to the owner.[34] In effect it held, quite correctly, that the part of the owner's property which was taken was alone worth to the owner an amount measured by *all* the losses, direct and indirect, to which he became subject as a result of being deprived of its use. But most courts do not construe "value" in this broad sense; and when they wish to allow for such losses as severance damages, they find it necessary to adopt some rule of recovery other than one based merely on "the value of the part taken." For this purpose they have adopted one of two alternative rules in partial-taking cases. According to the minority rule, the total award is based on "the difference between the market value of the entire property before and after the taking." According to the majority rule, the award is based on "the value of the part taken plus damages to the remainder." But under the latter rule, the "value of the part taken" is interpreted to mean neither the low price for which that particular segment of the property could be separately sold, nor the high value that it had to the owner in saving his entire property from injury. Instead, it is a prorated value based on some arbitrary apportionment of the value of the larger whole—an utterly meaningless figure which makes difficult the computation of additional, "severance" damages. For this reason the minority rule is decidedly preferable.[35]

Value to the Taker as Affecting Just Compensation.[36]

Courts and textbook writers have often stated that the very purpose of the power of eminent domain is to exempt the condemner from the obligation to pay prices for properties dictated by its own necessities. Quite properly, therefore, the law has drawn the conclusion that the value of the property to the taker is not an acceptable measure of compensation. "And the question is what has the owner lost, not what has the taker gained."[37] But in police power reverse position

[34] Louisiana Society v. Board of Levee Commissioners, 143 La. 90, 78 So. 249 (1918).

[35] The Supreme Court has upheld awards based on either rule. Compare Bauman v. Ross, 167 U.S. 548 at 574 (1897), upholding an award based on the majority rule, with Olson v. U.S., 292 U.S. 246 (1934), accepting an award based on the minority rule. The Supreme Court, like most lower courts, apparently treats these two rules as merely different methods of reaching the same total award.

[36] See Orgel, *op. cit.*, Chap. 6, and our earlier article, "Value to the Taker in Condemnation Cases," by Robert L. Hale, 31 *Col. L. Rev.* 1 (1931).

[37] Boston Chamber of Commerce v. Boston, 217 U.S. 189 at 195 (1910). The courts have often reversed this position when deciding what specific items of

But while uniformly rejecting value to the taker as the *measure* of compensation, the courts have often been far from clear that they wish this value to be utterly disregarded as an indirect factor in the award. "Market value for all available uses" is the accepted test, and the question arises whether, and under what conditions, the taker's special use for the property may be brought in as an "available use." The opinions on this point are both confusing and irreconcilable.

The question is presented in its clearest form where the special value to the taker is based on a use which no private owner, unarmed with the power of eminent domain, could derive from the property. This would apply, for example, to the naval and military value claimed by the former owners of the Cape Cod Canal when the United States government took over the property.[38] It would also apply, with rare exceptions, to claims of special value of land for railroad purposes, and to most claims based on the adaptability of land for a large water-supply reservoir.

On this issue there is a confusing line of opinions by the United States Supreme Court. *Mississippi & Rum River Boom Co. v. Patterson,*[39] often called the leading case on value to the taker, required a company possessing the power of eminent domain to pay a specially computed allowance for the boom value of islands otherwise almost worthless; but the opinion of the Court defended the holding on the ground that the owner himself might have made similar use of the islands. *Shoemaker v. United States*[40] upheld a lower court for refusing to instruct the commissioners that if the land "is peculiarly adapted to some public use,—*e.g.*, to the use of a public park,—all the circumstances which make up this adaptability may be shown." *United States v. Chandler-Dunbar Co.*[41] throws doubt on the subject by its rejection of an allowance made by the court below for the "strategic value" of an island condemned for navigation purposes by the United States government, although it sustained an allowance for the availability of the land for lock and canal purposes. The following quotation from the opinion of the Supreme Court, by Justice

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property have been "taken" (for which compensation must be paid) and what other items have merely been injured or perhaps completely destroyed by act of government, but which need not be paid for. Here the issue may depend on the question whether or not the condemner has taken over the property for its own benefit.

[38] See U. S. v. Boston, Cape Cod & New York Canal Co., 271 Fed. 877 at 893 (C.C.A. 1st, 1921).

[39] 98 U.S. 403 (1878).

[40] 147 U.S. 282 (1893).

[41] 229 U.S. 53 (1913).

Lurton, illustrates the difficulty of making definite meaning out of the cases:

> Although it is not proper to estimate land condemned for public purposes by the public necessities or its worth to the public for such purposes, it is proper to consider the fact that the property is so situated that it will probably be desired and available for such a purpose.[42]

McGovern v. New York[43] seems to undo the confusion of the *Chandler-Dunbar* case, through an opinion, written by Justice Holmes, affirming the New York courts in excluding evidence in proof of the enhanced value of land for reservoir purposes. And the opinion, also written by Justice Holmes, in *New York v. Sage*[44] supports the same point of view. But during the very year when the *McGovern* decision was rendered, Justice Hughes, speaking for the Court in the *Minnesota Rate Cases*,[45] remarked that if land condemned for a railroad right of way "had a peculiar value or special adaptation for railroad purposes, that would be an element to be considered." Yet he also said that "the owner would not be entitled to demand payment . . . of an enhanced value by virtue of the purpose for which it was taken."

Olson v. United States,[46] involving the condemnation of flowage easements in the land bordering Lake of the Woods, the level of which was to be raised under a treaty with Canada, supported the state court in awarding to the riparian owners nothing but loss of market value for agricultural (and fishing) purposes, despite the owners' claim to a payment for reservoir value. The *decision* therefore required no allowance for the peculiar use for which the easements were condemned. But Justice Butler, speaking for the Court, reiterated the doctrine that the owners were entitled to compensation for a "fair market value" based on *all* available uses, including power-development use. He merely denied that, in this instance, the multitude of individual landowners could in fact have joined forces so as to sell their combined easements for power purposes. To quote from his opinion:

> The fact that the most profitable use of a parcel can be made only in combination with other lands does not necessarily exclude that use from consideration if the possibility of that combination is reasonably sufficient to affect market value. Nor does the fact that it may be or is being acquired by eminent domain negative consideration of availability for use in the public service. *New York v. Sage*, 239 U.S. 57, 61. It is common knowledge that

[42] *Ibid.* at 77.
[43] 229 U.S. 363 (1913).
[44] 239 U.S. 57 (1915).
[45] 230 U.S. 352 at 451–452 (1913)
[46] 292 U.S. 246 (1934).

These competitive condemners

public service corporations and others having that power frequently are actual or potential competitors, not only for tracts held in single ownership but also for rights of way, locations, sites and other areas requiring the union of numerous parcels held by different owners. And, to the extent that probable demand by prospective purchasers or condemners affects market value, it is to be taken into account. *Boom Co. v. Patterson*, 98 U.S. 403. But the value to be ascertained does not include, and the owner is not entitled to compensation for, any element resulting subsequently to or because of the taking. Considerations that may not reasonably be held to affect market value are excluded.[47]

The lower Federal court and state court opinions form a hopeless web of conflict and obfuscation. The opinion of the Circuit Court of Appeals in the *Cape Cod Canal* case[48] apparently accepted the full logic of the argument against consideration of special value for the taker's use. And other decisions to the same effect can be found, such as those denying the right to prove claims of the special value of land for railway purposes,[49] or the special value of land for a bridge site.[50] But apparently similar claims have also often been recognized, as in cases of claims for special railway value.[51]

In our separate article written by Robert L. Hale, cited at the beginning of this section, and in the chapter on value to the taker in Orgel's volume on eminent domain, we have noted several possible distinctions between the cases that include and those that exclude the special uses of the taker as enhancing market value. Sometimes the distinction seems to hinge on the question whether the owner himself, or some prospective purchaser unarmed with the power of eminent domain, could have exploited the property for the same use. Sometimes it seems to depend on the question whether the value to the taker has become "embodied in the market value of the property" as a result of actual sales of the same or similar property based on the hope of resale to the taker itself, or of condemnation by the taker, at an inflated price. Several of the opinions, including some of the United States Supreme Court, suggest a distinction between such values to the taker as are thought to be based on his "necessities" (which should not be allowed) and such values as are due to the peculiar merits of the property (which may be "considered"). Presumably, a railway is forced by "neces-

[47] *Ibid.* at 256.

[48] *Supra* note 38.

[49] Union Depot, etc., Co. v. Brunswick, 31 Minn. 297 at 299 (1883).

[50] Sullivan v. Lafayette County, 61 Miss. 271 at 282 (1883).

[51] See Oregon River & Navigation Co. v. Taffe, 67 Ore. 102, 134 Pac. 1024 (1913); Gurdon & Fort Smith R. Co. v. Vaught, 97 Ark. 234 at 241–242, 133 S.W. 1019 at 1023 (1911).

sity" to acquire an ordinary farm tract that lies along its planned right of way; but its desire for a peculiar tract, say in a gorge, is based on the high merit of the property and calls for compensation. For some unexplained reason, the courts imply that the private owner has a special claim to reap a reward for the work of God!

But any distinction that may seem applicable to one given set of cases, will break down if applied to other cases. The development of a definite and satisfactory distinction between market value and value to the taker is a task for the future.

Evidence of Market Value.

In eminent domain no less than in other legal appraisals, the formal definitions of value are so inadequate that one must infer the meaning of the term by reference to the opinions and instructions on questions of evidence. A detailed analysis of the rulings on evidence appears in our separate monograph on eminent domain by Lewis Orgel. Here a brief summary must suffice.

In general the data that are presented to the tribunal as tending to prove the value of the property are of two forms. The first form is that of testimony by qualified witnesses, particularly by real-estate men, builders, and professional appraisers, as to their own opinions of the value of the property. The second form is that of data supposedly bearing on value, on the basis of which the judge or jury may independently estimate what the property is worth or may, at least, check the estimates of the hired experts. Records or estimates of actual cost, replacement cost (minus allowance for depreciation), actual rentals or rental values, actual sales of the same or similar properties, sometimes bids and offers, are of this order and are generally admitted under certain restrictions. Often one party or the other, generally the owner, attempts to introduce records of the recent profits of the business located on the premises, or estimates of future profits, as capitalizable on the "earning-power" basis of valuation. But, for reasons to be mentioned later, most courts have held that estimated future profits are inadmissible in proof of value; and they have even excluded reported *realized* profits save in rare instances.

In New York State, at least, where Mr. Orgel has made an elaborate study of the records of the cases between the years 1926 and 1932, the courts appear to have relied very largely on expert-opinion estimates rather than on other data. This is natural, as most judges are novices in appraisal technique. But the results have been far from fortunate, as indicated by a scrutiny of a series of New York City condemnations revealing a striking tendency to base the award at almost the precise

mid-point between the highest value testified to by a witness for the owner and the lowest value testified to by a witness for the taker.[52] Thus a premium has been placed on the most blatant expert exaggerations.

Aside from opinion estimates, the data that have been most frequently introduced are estimates of the replacement cost of the structure plus the current market value of the vacant land—the latter value being inferred either from the recent sale prices of similar land or else from opinion testimony. More often than not, this emphasis on replacement cost has resulted in overvaluations even when the replacement cost itself is not exaggerated by the inflationary tactics of experts for the owner. Improved real property, unless it is almost new (and not even always then), is seldom worth its replacement cost. To be sure, the courts require that an allowance be made for depreciation, including so-called functional depreciation as well as physical deterioration. In practice, however, this allowance is almost invariably inadequate. A jury or court is seldom willing to make those drastic allowances for the value deterioration of an expensive and impressive building that a shrewd businessman would make if he were buying the property for his own use.

Original Cost as Evidence of Value: The Forty-second Street Elevated Spur Case.

When the condemned property has been recently purchased or constructed by its present owner, the actual cost to this owner is admissible evidence of value and is often given much weight. As a matter of formal doctrine, at least, this cost is supposed to be relevant only in so far as it may indicate what the property was "actually worth" at the time of the taking, and not because of any principle that the owner is entitled to recoup his actual investment. One may suspect, however, that juries and even judges are often influenced by a feeling that an owner should secure for his property at least the amount of money that he put into it.

Indeed, one of the most distinguished courts, the New York Court of Appeals, seems to have been under this influence when it recently set the award in the condemnation by New York City of the Forty-second Street Elevated spur.[53] The condemned spur had been losing money for the railway company, and there was no prospect that it would ever become profitable. Looked at from the principle of indemnity, one

[52] See the Wallstein report, *supra* note 17, at p. iv.

[53] Matter of City of New York (Manhattan Ry. Co.), 265 N.Y. 170, 192 N.E. 188 (1934), *aff'd sub nom.*, Roberts v. City of New York, 295 U.S. 264 (1935).

might therefore assume that the company was entitled merely to nominal compensation, since it apparently lost nothing of value when its structure was taken down. Indeed, the opinion indicates that the property was an actual liability, as it imposed on the company the obligation of maintenance and operation. As a matter of fact, the Court of Appeals upheld the Appellate Division in allowing mere junk value for the structure and no value whatever for the franchise. On this point it adhered strictly to the principle of indemnity for loss actually sustained.

But another item of property was involved—the easements of air, light, and access that had belonged to the adjacent property owners and for which the company had been compelled to pay $539,117 when the structure was erected, many years ago. These easements were worth nothing to the company for its business, since its business on the spur was worth nothing. Their only possible value to the company lay in what has been called their nuisance value, that is, in the opportunity that the company might have had to sell them to the abutting property owners. In his dissenting opinion, Judge Lehman argued that such a value, if it could be established, should be taken as the basis of compensation. But the court upheld the Appellate Division in requiring the city to pay compensation for the easements based on their *original cost.* Said Chief Judge Pound in speaking for the court:

> In other words, the property in such easements, strictly speaking, *is of no value to the railroads* when the railroad ceases to operate and is taken out of the street, but the city should reimburse the railroads for what it cost them to acquire such easements when it terminates the right of use in perpetuity. (Our italics.)[54]

The chief interest of this case lies in its virtual abandonment both of the doctrine of indemnity and of the rule of present value as a measure of "just compensation" under the law of eminent domain. Original cost was adopted, not on the theory so frequently advanced in utility-rate cases and sometimes advanced in condemnation cases, that it happens to be the best available *measure* of present value, but rather on the theory that, under the peculiar circumstances, it constitutes a *fairer* basis of compensation than would present value itself.

The review of the *Forty-second Street Spur* case by the United States Supreme Court is important; for the highest court, speaking through Justice Cardozo, apparently did not accept the apologetics by which the Court of Appeals had defended a valuation of the easements at their original cost of acquisition. While upholding the New York

[54] 265 N.Y. at 181, 192 N.E. at 190.

courts against the company's contention that the award failed to grant the "just compensation" required by the Fourteenth Amendment, the Supreme Court stated (without having occasion to decide the issue) that the state courts might have been overgenerous in allowing anything whatever for easement value. It noted, in the first place, that under the doctrine against an allowance for "value to the taker," the only easement value to be considered would be value to the company itself, which in turn would have to be based on the opportunity that the company would have possessed, had its spur not been condemned, to induce the abutting property owners to pay it a price for tearing down the unprofitable structure. Whether or not the company's loss of such an opportunity requires a payment of "just compensation" is an arguable question:

Implicit in such an argument are assumptions that would be worthy of scrutiny if the need for scrutiny were here. The inquiry would then be whether easements or quasi-easements inseparable from a franchise must be paid for as property at the peril of infringing the Fourteenth Amendment when their value for sale presupposes the abandonment of the franchise to which they are appurtenant. To carry the amendment to that point approaches, though it may not touch, the acceptance of the nuisance value which Hough, J., on one occasion excluded from the reckoning with words of trenchant emphasis (Consolidated Gas Co. v. City of New York, 157 Fed. 849, 874 (1907)). For the time being and provisionally we put aside these doubts, resolving in favor of the company whatever problems they suggest.[55]

Coming, then, to the factual question whether the company could have induced the abutting property owners to pay it a high price for a surrender of its franchise, the Court expressed grave doubt whether the effort would have been successful. Under the circumstances as they stood, "union among the abutters was a shadowy and distant chance" (citing *City of New York v. Sage*, 239 U.S. 57 at 61 (1915), and *Olson v. United States*, 292 U.S. 246 at 256 (1933)).

The position thus taken by the Supreme Court was in line with orthodox law, according to which the original cost of property has no bearing on "just compensation" unless it happens to have a bearing on "value at the time of the taking." On this particular point of law the Court, by dictum, agreed with the dissenting opinion of Judge Lehman rather than with the prevailing opinion of the Court of Appeals.

Capitalized Profits of a Business as Evidence of the Value of the Premises.[56]

One of the most hotly contested questions of proof concerns the admissibility of the realized or prospective profits of a business as

[55] 295 U.S. 264 at 283 (1935).

[56] See Orgel, *op. cit.*, Chap. 14.

evidence of the value of the premises. We have already noted that this type of evidence is usually held inadmissible—the prophesied future profits even more generally so than the reported realized profits. At first thought, the exclusion of the testimony would seem to run directly counter to the "capitalized-income" theory of valuation, discussed in Chaps. XI and XII—a theory which has been generally accepted by modern appraisers and which has been used to discredit appraisals based on estimates of replacement cost minus conventional deductions for depreciation. Further consideration, however, gives much support to the courts in their reluctance to admit the evidence unless the tribunal to which it is submitted is itself composed of experts who are fully on guard against its misleading implications.

The first, and often fatal, objection to its cogency is that the property which is expropriated, and for which compensation must be paid, ordinarily covers merely the real estate and not the business as a whole. Consequently, even if the value of the entire business could best be estimated by a capitalization of its profits, the difficulty of deriving from that aggregate value the value of the condemned tract of land and structures would usually be insurmountable.

The second objection is that a capitalization of profits already *realized* means nothing unless these profits may be expected to continue; whereas a capitalization of *prophesied* profits involves a series of forecasts subject to a critical margin of error, yet extremely difficult to discredit on cross-examination.[57] For these reasons, the capitalized-profits method of valuing improved or unimproved land should be employed only as a last resort, when other, more reliable evidence is not available. The actual recent sale prices of adjacent or substantially similar properties, despite the inferential difficulties to which they give rise because of the fact that most properties are, in some respects, unique, are ordinarily a far safer guide than are the profits which biased experts for the litigants *say* that they *believe* that the business would yield.[58] Especially in the hands of inexpert tribunals, an appraisal

[57] This point was clearly recognized by the New York Court of Appeals in reversing the judgment of a lower court, which had valued certain quarry lands, condemned by the state, at a figure apparently based on a capitalization of anticipated profits. Sparkill Realty Corp. v. State of New York, 268 N.Y. 192, 197 N. E. 192 (1935), citing earlier New York cases rejecting the valuation of real property by a capitalization of profits anticipated from its exploitation.

[58] Unfortunately, testimony of the actual sale prices of adjacent properties has been held inadmissible in proof of the value of condemned property, in New York and a few other jurisdictions. In his special report on New York City condemnations, *supra* note 17, Leonard Wallstein recommended that the state legislature make the testimony admissible; and statutes to this effect have already been

based on capitalized estimated profits is almost sure to result in a gross overvaluation. The novice at appraisal simply cannot bring himself to apply those amazing discounts for the risk factor that are required in an intelligent capitalization of estimated paper profits.

There are some situations, however, which demand an appraisal of real property by reference to a capitalized-profits method; otherwise, a gross overvaluation is almost unavoidable. These are situations where business structures are clearly not worth their replacement cost, and where their unique nature precludes a valuation by reference to recent sales of similar properties. Here, the value of the business located on the premises, as estimated by a capitalization of anticipated earnings, may be required in order to set the *upper limit* of the value of the premises themselves. For example, the value of an insolvent hotel property, or of a factory which belongs to an unprosperous business and which is ill-adapted for other uses, is almost sure to be far less than its replacement cost minus standard deductions for depreciation. Yet, unless an actual sale of the premises has recently taken place, the amount of this impaired value is indeterminate without reference to the prospective profitableness of the hotel company or the manufacturing company. Unfortunately, the courts have not always seen the full force of this point. Instead, they have often sanctioned valuations of unprosperous properties at the estimated market value of the vacant land plus the replacement cost of the structures minus purely arbitrary or conventional deductions for depreciation.[59] This judicial tendency to stick to a so-called "physical valuation" even with respect to property that is clearly not worth replacing in its present form, constitutes one of the reasons for the chronic overvaluations that characterize awards under the law of eminent domain.

Condemnation of Public-utility Properties.[60]

The current public interest in government ownership of utilities, which is an outgrowth of the widespread dissatisfaction with private operation under the "present-value" rule of rate regulation, gives special importance to the measurement of compensation payable to

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enacted with respect to condemnations in Greater New York and to condemnations triable in the Court of Claims.

[59] For example, in the condemnation of the Libby Hotel property in New York City, Matter of City of New York (Chrystie Street), 236 App. Div. 321, 258 N.Y. Supp. 243 (1932) (two judges dissenting), *aff'd*, 260 N.Y. 583, 184 N.E. 102 (1932).

[60] Orgel, *op. cit.*, Chaps. 17–21; Note, "Municipal Acquisition of Public Utilities," 34 *Col. L. Rev.* 534 (1934); Whitten and Wilcox, *Valuation of Public Service Corporations* (2d ed., New York, 1928), Vol. I, Chaps. 4 and 13.

the owners of condemned utility plants. In formal legal doctrine, the same measure of compensation is applicable here that is applied to an ordinary real-estate condemnation. That is to say, the owners are entitled to "just compensation," which in turn is usually held to be measured by the "market value" or "fair market value" of the property at the time of the taking, plus possible allowances for severance damages. But the actual valuation presents problems of a distinctive nature which call for special treatment. From the viewpoint of value theory, chief interest lies in the comparison between the principles of valuation for rate-making purposes and the principles by which the same property is valued under the much older and more traditional law of eminent domain. The import of this distinction can best be understood if the present section is read in conjunction with Chaps. XXX and XXXI, on valuation for rate-making purposes.

Distinctive Character of a Public-utility Condemnation.

Writers on the law of eminent domain have often emphasized the paucity of actual sales of utility plants (distinct from the sales of utility *securities*) as the source of most differences between valuations of these properties and valuations of ordinary condemned real estate. In the latter cases, actual sales of the very property in question, or of similar property, may often serve as the basis of valuation; in the former cases, other evidence, such as replacement cost or capitalized earnings, must usually be relied upon.

In fact, however, this distinction is by no means the most important one. A far more significant characteristic of a utility condemnation is that it typically deprives the owners of their entire business enterprise (or of a part of their enterprise) and not merely of certain replaceable assets of their business. If a city condemns, say, a grocery-store property or a factory site and building, in order to build a courthouse on the site, it usually still leaves the occupant in a position to save his business by moving to other premises. Under these circumstances, compensation is paid only for the improved land that is taken, but not for the business itself. To be sure, the necessity of relocation may result in material damages, such as impairment of good will and delays and expenses of setting up business in the new premises. But these so-called "incidental" damages are regarded as typically so unimportant in amount or so difficult of measurement that doctrinal law declines to allow for their recovery.[61] But if a city condemns the dis-

[61] *Supra* note 6. In the Banner Milling Co. case, cited in this earlier footnote, the New York Court of Appeals drew the same distinction that we are here drawing between a utility condemnation and the taking of ordinary real property.

tribution system of an electric-light company, it precludes the company from continuing business in that district.

Under these circumstances, the traditional distinction in eminent domain between the real property that is taken and the business or "going concern" that is merely incidentally injured, becomes almost meaningless. And a recognition of this fact has led the courts, in effect, to treat the condemnation of a utility plant (when that plant is of such a nature that its owners could not keep their business going by replacing it) as if the business itself, and not merely the real property, had been taken by the government.

The above statement is true in a broad sense, although the law is still hazy as to its concept of the property that is taken in a utility condemnation. In former years, at least, the most disputed question concerned the claim of the companies that they must be compensated, not merely for the loss of their land and structures, but also for the value of their special franchises to operate a utility business. Relying on the thesis that a "taking" means, not merely a *destruction* of property values, but also a taking over of property by the condemner, counsel for the condemning governments argued that no payment need be made for franchise value, since the government was obviously not receiving a grant from itself. The courts, however, repeatedly held that a franchise is "property" of which the owner may not be deprived without the payment of "just compensation";[62] and the legalistic distinction between a taking and a destruction was largely ignored.

These early decisions requiring compensation for franchise value still represent the doctrinal law of the land in the absence of a provision in the franchise, or of a statute passed before the granting of the franchise, precluding such a claim in the event of expropriation by the government.[63] But their import has become doubtful in view of the recent trend of the courts against the allowance of any special claim for franchise value in rate cases,[64] coupled with their insistence, both in rate cases and in condemnation cases, that an allowance must be made for any "going value" that is found to exist. To be sure, Justice Brandeis,

[62] The "leading case" is Monongahela Navigation Co. v. U. S., 148 U.S. 312 (1893).

[63] Under the so-called "indeterminate permits" in vogue in Wisconsin and elsewhere, which supersede a franchise for a specified term of years, it has been held that a municipality which takes over the utility plant is not obliged to pay for "franchise value." The franchise itself comes to an end when the government exercises its option to take over the plant. Appleton Waterworks Co. v. R.R. Commission, 154 Wis. 121, 142 N.W. 476 (1913).

[64] *Infra* pp. 1143–1145.

in his concurring opinion in the *Southwestern Bell Telephone* case,[65] noted the obligation to pay for franchise value as one of several distinctions between an appraisal under the law of eminent domain and a valuation for rate-making purposes. But the question may fairly be raised whether a rule of rate making denying specific allowance for franchise value will not preclude the company from establishing such a value in a compulsory purchase. A value of which the company may not take advantage so long as it continues to do business under commission regulation, can hardly be set up as a value of which the company is *deprived* when its opportunity to continue business under regulation is converted into a claim for a lump-sum indemnity.

While it may therefore be doubted whether a regulated utility can successfully claim a special allowance under the heading of "franchise value," much the same result may be reached under the holdings of the courts, applied alike in compulsory purchases and in rate cases, declaring that "going value," if found to exist in fact, must be included. Although the going-value doctrine seems to have had its origin in the former type of cases,[66] only later being transferred to the latter, most of the recent controversies as to its nature and measurement have arisen in rate proceedings. We therefore reserve discussion of the subject for Chap. XXXI, on valuation for rate-making purposes. Orgel, however, gives special attention to the analogous holdings under the law of eminent domain. While he finds no sharp distinction on this point between the two fields of law, he notes a judicial tendency to construe "going value" in the condemnation cases in terms of excess earning capacity, contrasted with a tendency to construe the same phrase in rate cases as a synonym for capitalized development costs.

Failure of the Courts to Accept the Full Logic of the Idea That a Condemnation of a Utility Property is Really a Condemnation of a Business.

The courts, through their insistence that the "just compensation" payable in a utility condemnation requires payment for any franchise value and/or going value that may be found to exist in fact, have gone a long way toward breaking down the distinction, still of much importance in ordinary real-estate condemnations, between the tangible property that is taken and the business enterprise that is merely incidentally injured. But they have by no means broken completely with the early traditions.

[65] Southwestern Bell Telephone Co. v. Public Service Commission, 262 U.S. 276 at 289 (1923).

[66] National Waterworks Co. v. Kansas City, 62 Fed. 853 (1894), a condemnation case, is cited as starting the line of precedents in favor of an allowance for going value.

A complete breach would have called for the valuation of the utility company's enterprise as an organic whole, with only such incidental reference to the so-called values of the separate assets, tangible and intangible, as might be required in order to throw light on the ultimate objective—the net earning power of the going concern. It would have resulted in the adoption of such methods of valuation as have been used in the assessment of a railroad, telegraph, or express-company enterprise under the unit rule of ad valorem taxation.[67] Emphasis would have been placed on the current market prices of outstanding utility securities, or on prospective earnings as indicated by the record of past earnings.

In some of the early utility condemnations preceding the announcement of the "fair-value" doctrine of rate making in *Smyth v. Ames*,[68] the courts seem to have been moving precisely in this direction. Thus in the *Monongahela* case,[69] decided in 1893, the Supreme Court, speaking through Justice Brewer, came close to saying that the value of a public-utility property is simply the value of the company's business enterprise viewed as a prospective source of revenue to its stock and bond holders:

> The value of property, generally speaking, is determined by its productiveness—the profits which its use brings to the owner. Various elements enter into this matter of value. Among them we may notice these: Natural richness of the soil as between neighboring tracts—one may be fertile, the other barren; the one so situated as to be susceptible of easy use, the other requiring much labor and large expense to make its fertility available. Neighborhood to the centres of business and population largely affects values. . . . Demand for the use is another factor. . . . The value, therefore, is not determined by the mere cost of construction, but more by what the completed structure brings in the way of earnings to its owner. . . . [70]

But the judicial development of this sound economic doctrine was sidetracked, or at least confused, in the 1890's and later, by the newer concept of "fair value" for rate-making purposes—a fallacious hybrid concept which partly identified, partly distinguished, the idea of value and the ideas of original cost or cost of reproduction. These rate-making doctrines soon had their repercussion on the compulsory-purchase cases. In consequence, the courts have tended to compromise between the notion that a taking of a utility property means a taking of a physical plant, and the notion that it means a taking of an enter-

[67] Chaps. XVIII–XX, especially pp. 613–630.
[68] 169 U.S. 466 (1898). See *infra* pp. 1094 *et seq.*
[69] *Supra* note 62.
[70] 148 U.S. 312 at 328.

prise. The compromise has taken the form of a so-called valuation of the plant as physical property, by reference to estimates of replacement cost or original cost, coupled with *additional* allowances for intangible "elements" of value.

The summation of the tangibles and the intangibles gives a figure of doubtful significance, and it would hardly be acceptable except to people who have a confused notion of property (and of property value) that hangs in mid-air between identifying property with physical things and identifying it with expectation of future profits. But precisely this type of confusion is characteristic of the modern law of property. How it may be resolved in the future is still uncertain. On the one hand, there is the possibility that the earning-power standard of valuation may be adopted with logical consistency, so-called physical value being ignored except as an indirect clue to probable future earnings. On the other hand, the courts may possibly identify value in a purchase case with that pseudo-value that they have more recently developed as the basis of rate control. At the present time both of these notions, despite their inconsistency, are alike operative. Their influence will be noted in the following sections.

Distinctions between Value for Rate-making Purposes and Value as a Measure of Just Compensation.

Perhaps the most intriguing problem in the whole field of legal appraisal concerns the much-disputed question whether, and in what respects, the "fair value" of a property when used as a standard of rate making means essentially the same thing as does the term "fair value" or "fair market value" when applied in other, more traditional, fields of law. This problem is treated at length in Chaps. XXX and XXXI, on valuation for rate-making purposes. The present section will confine itself to a comparison between the rules of valuation applied in rate cases with the rules applied to the very same type of properties in a compulsory taking. But the reader should be warned against exaggerating the significance of the highly similar rules applied in these two situations. For, with respect to utility properties, the law of condemnation has itself been decidedly influenced, not to say distorted, by the more recent but far more prominent principles of valuation adopted in the rate cases. It by no means follows that, because the courts have often failed to distinguish between the value of a utility plant in a rate proceeding and its value in a condemnation case, therefore they have also failed to make any vital distinction between value in a rate case and value in the condemnation or taxation of a factory building, or of a residence property, or of a textile business.

The first point to note is that, with certain exceptions, the courts require the inclusion of the same "items" of property in both proceedings. To be sure, condemnations may omit payment for certain assets, such as movable chattels and working capital, for which allowance must be made in the rate cases. Moreover, the condemner, if it expropriates company property not presently "used and useful in the public service," must pay for this property even though it might be omitted from the inventory in a rate case under the rule in *Smyth v. Ames*.[71] But, save for these obvious differences, essentially every "asset" that goes into the rate base, also goes into the claim for "just compensation" unless it is excluded by the terms of the franchise or of a statute passed before the acquisition of the franchise; and vice versa. On the one hand, tangible properties (land, structures, equipment) are included, as are allowances for going value, water rights, and other so-called intangibles. On the other hand, good will is excluded on the ostensible ground, generally conceded by experts to be unsound, that a monopoly has no good will in fact.[72] Even with respect to such a detail as the claim by the company for an allowance for the estimated cost of repaving over gas mains or underground wires, the same doctrinal rule is applied—it is usually excluded alike under the law of eminent domain[73] and of rate making.[74] To be sure, the cases in eminent domain requiring payment for franchise value do not seem to square with the more recent cases in rate making refusing to make special allowance for any such value. But we have already suggested that this distinction is no longer of clear import.

It is only when we turn from the inventory of *items* of property to be included, and consider the principles by which these items are assigned specific monetary values, that we find significant divergences between the appraisal features of the two fields of law. But even here the distinctions are by no means clear cut. Comparison is rendered extremely difficult by the fact that in neither field have the courts revealed any precise concept of "fair value" as the "fact to be found." The absence of adequate formal definitions of either kind of value leads one to turn to the rulings on evidence for possible distinctions. But

[71] *Supra* note 68.

[72] See *infra* p. 1146.

[73] Appleton Waterworks Co. v. Railroad Commission, 154 Wis. 121, 142 N.W. 476 (1913); Oshkosh Water Works Co. v. Railroad Commission, 161 Wis. 122, 152 N.W. 859 (1915). *Contra:* Wichita Water Co. v. City of Wichita, 271 Fed. 973 (1921), *rev'd on other grounds,* 280 Fed. 770 (1922). See Whitten and Wilcox, *Valuation of Public Service Corporations* (2d ed., New York, 1928), Chap. 18.

[74] Cedar Rapids Gas Light Co. v. Cedar Rapids, 223 U.S. 655 (1912); Des Moines Gas Co. v. Des Moines, 238 U.S. 153 (1915).

most of these rulings are too vague to be of much help. In both fields, for example, original costs of the tangible properties *as well as* replacement cost are generally recognized as relevant data. But just why both data are deemed simultaneously relevant is seldom stated. Actual findings of values for rate making and for condemnation would furnish the best clue to a solution of the problem if only they were available. But we are unaware of any reported case in which an appellate court has placed values upon substantially the same property at approximately the same time, for both purposes.[75] The use of the deadly parallel in quantitative terms is therefore ruled out.

The Supreme Court has not yet made it clear whether it conceives of value for rate-making purposes to be something different from value for other purposes, especially from the value that is protected from unrequited seizure under the "just-compensation" clause of the Fourteenth Amendment. To be sure, Justice Brandeis drew a distinction between the two in his dissenting opinion in the *Southwestern Bell Telephone* case.[76] But his remarks hardly reflect the viewpoint of the more conservative members of the Supreme Court. Of these latter members Justice Butler's views are perhaps more representative. They were expressed most clearly before he came upon the bench and while he was acting as attorney for various railroad companies in rate cases. He then insisted that the notion of a special value for rate-making purposes, different from the more traditional value applicable under the laws of eminent domain or of taxation, is quite invalid.[77] His subsequent opinions in rate cases suggest an unchanged point of view and are apparently supported by the freedom with which he has cited rulings on evidence in condemnation cases as applicable to rate cases, and vice versa. We discuss his position at greater length in the chapters on valuation for rate-making purposes.

Among the writers on legal valuation there seems to be fairly general agreement that value in condemnation cases is not construed by the courts to be the same thing as value in rate cases. In a condemnation, they point out, the assumed objective is the *market* value of the property—that is, the price at which the utility enterprise could

[75] Even public service commissions, in awarding compensation for condemned or purchased properties, have not stated what valuations they have placed, or would have placed, on the same properties for rate-making purposes. In two California condemnations the commission said that it had "considered" value for rate-making purposes, but it did not state what these values were found to have been. Re Los Angeles, P.U.R. 1916 F, 593 at 598 (Calif. R.R. Comm.); Re Palo Alto, P.U.R. 1917 A, 163 at 180 (Calif. R.R. Comm.).

[76] *Supra* note 65.

[77] *Infra* pp. 1104–1108.

actually have been sold to some private purchaser had it not been condemned, or alternatively, the price at which it would be sold as between a suppositious willing buyer and a willing seller in the light of prospective profits derivable from its operation. From this theory it would follow that the value of the property must depend entirely on prospective net earnings, since these earnings constitute the one thing that would make ownership of the enterprise desirable to a buyer or seller. Replacement cost, original cost, and all the other data that are given dominant weight in a rate case, are literally irrelevant, save in so far as they may possibly affect future earnings in various indirect ways, such as through their influence on the rates that will be sanctioned by courts and commissions. What the owner has lost, when he is deprived of his interest in a railroad or in an electrical plant, is not a tract of land with some structures on it, but rather the chance of securing interest and dividends from his investment. The principle of indemnity requires that he be given an amount of money which will roughly compensate him for his lost chance.

But valuation for rate-making purposes, these writers point out, has an entirely different objective. It is really an attempt, not to *find* what the property is worth—for that worth depends on the rates that may be charged, which are the very matters in dispute—but rather to *fix* a rate base in some proper relation to cost, either actual cost or replacement cost. Hence, "value" in a rate case is not properly value at all, but some fair amount measured largely by cost. Of course a valuation placed upon property for rate making may greatly influence the commercial or market value of the property and in rare cases may approximately measure it. But the two things are distinct, and a court may conceivably find that a property which is "worth" $5,000,000 for rate-making purposes, is worth $4,000,000 or $6,000,000 in a condemnation case.

As an expression of correct economic principle, the above distinction is sound. To what extent, however, it reflects the actual practice of the courts in valuation cases is doubtful. Judicial statements, to be sure, can be found in support of this point of view. One may note, for example, that in utility condemnations the courts have usually said that the value to be found is "market value" or "fair market value," whereas in rate cases the Supreme Court has constantly referred to "fair value" as the desideratum and has never said that this means market value. Still more significant is the fact that realized earnings are held to be admissible evidence of value in a compensation case, whereas in rate cases the Supreme Court has several times stated that a valuation based on earning power would be inappropriate, since the fair

amount of the earnings is itself in dispute. But when one reads the entire opinions in most condemnation cases, one finds that in practice, the very items that are given dominant weight in rate cases, namely, records of actual cost, estimates of replacement cost and of depreciation, arbitrary allowances of 10 per cent or 15 per cent or what not for going value, also play the controlling role in this other type of litigation. It is seldom possible to conclude with confidence that the value actually sustained in a rate case would differ from that which would be sustained were the issue one of compensation under the law of eminent domain. On the whole, there seems to be a tendency toward greater liberality in the latter than in the former, and also a tendency to place more emphasis on replacement cost and less on actual cost. But such a tendency, if it exists, is unsupported by any formal rulings.

Capitalized Earning Power versus So-called Physical Value as a Measure of Just Compensation.

The nubbin of the question as to a distinction between value as a measure of compensation and value as a basis of rate control is to be found in the relative weights accorded to prospective earning power and to so-called physical values (that is, actual or replacement costs, with allowances for depreciation) in the two fields of valuation. Under the law of rate making, the mere fact that a utility enterprise may have but little commercial value because its realized and prospective earning power is slight, has not deterred the public service commissions and the courts from arriving at substantial values for rate-making purposes—values based largely on original or replacement costs minus conventional deductions for depreciation. Conversely, the mere fact that the utility possesses a commercial value far in excess of construction costs, because of its ability to earn excessive returns under whatever rate restrictions have been imposed upon it or seem likely to be imposed upon it in the future, has not led to the adoption of these excessive commercial or market values as the basis of rate making.

The question arises, therefore, whether the same complete or almost complete disregard for commercial value and the same emphasis on so-called "structural value" may be found in the awards sanctioned in condemnation cases. Suppose, for example, that a city were to expropriate a street-railway system on which has been placed a value of $10,000,000 for rate-making purposes, measured largely by replacement cost, but which has an intelligently estimated commercial value of only $1,000,000 because of its prospective inability to compete successfully against bus competition. What will detelmine het "just compensation" to which it is entitled? Or suppose on the other hand,

that the city condemns an electric distribution plant which has a rate-making value of $10,000,000 but which is reasonably estimated to be worth $15,000,000 as an investment opportunity because of a chronic indisposition by the commission or the courts to impair that earning power by enforced rate reduction. Will the city be compelled to pay $15,000,000 for the property, or only $10,000,000, or some intermediate figure that "takes into account" both earnings and "structural values"?

The paucity of reported cases clearly illustrating either of these two situations makes it impossible to give a general answer to this question. It is probable, however, that the third solution would be adopted by most courts and commissions and that some utterly meaningless compromise between commercial or market value and "structural value" would be arrived at. Certainly both the cost figures and the earning-power figures would be admitted as "evidence" of value and would be recognized as factors to be "considered."

In most cases, while the tribunals have conceded that the realized and prospective profits of the enterprise may properly be taken into account along with structural costs, they have nevertheless declined not only to give them dominant weight but even to accord them as much weight as is given to estimates of replacement costs minus allowances for depreciation.[78] On the one hand, profits already realized have been belittled on the ground that they may have been higher or lower than future profits and hence that they may not reflect what an intelligent buyer would pay for the property. But on the other hand, expert forecasts as to future profits have been discounted as being based on mere "speculation." Not only must any such estimates be based on unprovable assumptions as to future business conditions, but they must also be based on mere surmises as to what rates of charge would be sanctioned by commissions and courts during years to come. Accordingly, the courts have preferred, as a rule, to rely largely on more "objective" measures of value, particularly on engineering estimates as to replacement costs. No doubt the practical objections urged by the courts against capitalized earnings as a basis of valuation are well

[78] With a prosperous utility the tendency seems to be to value the physical property at depreciated replacement cost and to take earning power vaguely into account in arriving at any extra allowances for going value or other intangibles. With an unprosperous utility, even the physical property may be assigned lower values by virtue of the deficient earning power, perhaps through an unusual deduction for depreciation. In the extreme case of a physical property with no earning prospects whatever, the tribunal may allow nothing but scrap value, as did the New York Court of Appeals in Matter of City of New York (Manhattan Ry. Co.), *supra* note 53.

founded. But valuations based on replacement cost are indefensible if judged by the assumed objective of an award in condemnation, which is to indemnify the owners of the property for the loss. Difficult as it is to determine fairly the value of a business enterprise by estimating its future earnings, no alternative method of valuation is acceptable, unless one is content to use the market prices of outstanding stocks and bonds.

But it is not merely the practical difficulties of appraisal technique which have led to awards in condemnation differing materially from the values that would be placed upon utility properties by investors. Notions of fairness to the owners have also had their influence in causing tribunals to require compensation for condemned properties of unprofitable utility companies, materially in excess of an amount which would indemnify the owners for their loss. This point may be illustrated by two cases in which the award for the condemned utility property was fixed by a public service commission, under a special statute conferring this jurisdiction on the same body to which rate cases are referred. In *Re City of Oroville*,[79] the taking included both an electric-light plant and a gas plant. The latter had been consistently unprofitable and was separately appraised. In its opinion the California commission stated: "The controlling facts demonstrate, from the standpoint of the Company, its bondholders and stockholders, that to the present owner this property is not an asset but a liability." Yet, in the face of this admission, the commission awarded $50,000 as the value of the plant, which was almost exactly one-half of its cost of reproduction less depreciation as estimated by the commission's engineers. Just compensation in such a case, it stated, should lie somewhere between salvage value (the amount of which was not stated in the opinion) and "the depreciated cost of the property minus certain deductions."

The reason given by the commission for this frank departure from the principle of indemnity was that the value of the plant *to the city* should be "considered." The city, it was assumed, would need to maintain a gas plant even if the enterprise would be a losing venture to a private company. It should therefore be required to pay such a price as would allow it to earn fixed charges plus operating expenses. But the city "could make considerable savings" in overhead, possibly in charges for depreciation, in lower cost of money, and in the freedom of a municipal plant from taxation! Fifty thousand dollars was therefore fixed as representing a price which the city could well afford to pay.

In taking this position, the commission disregarded the frequent statements of the highest courts (asserted in utility condemnations

[79] P.U.R. 1922 E, 451 (Calif. R.R. Comm.).

as elsewhere throughout the law of eminent domain) that the measure of just compensation is, "what has the owner lost, not what has the taker gained."[80] It took the same position in *Re City of Eureka*,[81] which involved a street-railway property that had not even earned its operating expenses for 10 years prior to the taking. Compensation of $100,000 was awarded, as compared to estimates of between $40,000 and $50,000 for salvage value, of $235,000 for depreciated cost of reproduction, and of $133,000 for depreciated historical cost.

The reader who is puzzled by this undoctrinal generosity of the California commission, and by its amazing reference to the city's tax savings as a basis for a higher award, should take note that this particular commission has long been on record as favoring "liberality" of treatment to private investors. He should also bear in mind the hostility of most public service commissioners to government ownership of utilities.

A somewhat similar tenderness toward the investors in an unprofitable utility was evinced by the Wisconsin Railroad Commission in *Re City of Washburn*,[82] fixing compensation for the taking of a water works on June 22, 1922. The town was in the slough of a depression following a wartime boom, and the company's business had suffered seriously in consequence. Moreover, said the commission, "there are no prospects, so far as we can determine, that such decline is temporary or that substantial values will be reestablished." Yet, while stating that "certainly no purchaser having freedom of action would pay for this water-works property anything like the original investment or the present cost of reproduction," the commission awarded $50,000, as compared to an appraisal of $49,232 based apparently on depreciated historical cost, replacement cost minus depreciation being estimated at $91,599.

Another illustration of the condemnation of an unprofitable utility property has already been cited, the acquisition of the Forty-second Street spur of the Third Avenue Elevated Company in New York City.[83] Here the Court of Appeals followed the logic of the capitalized-earning-power basis of valuation in upholding an award for the elevated *structure* measured by mere scrap value. But it departed from this basis, and therefore from the principle of indemnity, by requiring the city to pay the company for the original cost of the easements of air, light, and access that the company had been forced

[80] Boston Chamber of Commerce v. Boston, 217 U.S. 189 at 195 (1910).

[81] 19 Calif. R.C.D. 952 (1921).

[82] P.U.R. 1924 D, 368 (Wis. R.R. Comm.).

[83] Matter of City of New York (Manhattan Ry. Co.), *supra* note 53.

to acquire from abutting property owners—a departure which the United States Supreme Court criticized by implication in reviewing the case.

Cases illustrating the situation where the investment value of the enterprise far *exceeds* the amount at which the property would be valued for rate-making purposes have not been revealed in any court or commission opinion that has come to our attention. A partial explanation is that the rules for determining the rate base have been so generous to the companies, that even an unusually prosperous enterprise may still have been worth no more than the amount of its rate base. An opinion of the California commission, however, throws light on this point: *Re Los Angeles*,[84] fixing compensation to the Southern California Edison Company for a distribution system. The commission first stated that "it seems difficult to understand why the just compensation to be paid in an eminent-domain proceeding should not ordinarily be at least equal to the rate base." Indeed, the rate base, it suggested, should be the starting point for the measurement of the award. But it indicated that the payment might properly exceed the rate base where the cost of money (6.003 per cent as testified to in this case) is less than the "fair rate of return" (8 per cent as assumed here), although account should be taken of the possibility that the difference in these two percentages might not persist in the future.

The actual award in this case (exclusive of severance damages) was $4,750,000, as compared to the commission's finding of $4,450,000 for actual cost and of between $4,800,000 and $5,000,000 for reproduction cost new of the physical plant. But the commission did not state at what amount it would have valued the property for rate-making purposes, beyond asserting that the proper rate base would be "considerably in excess of $4,000,000."

The California commission is perhaps the only tribunal to express so frankly, on the one hand its readiness to allow more than commercial value for an unprofitable utility, and on the other hand its willingness to allow more than the rate base for a profitable enterprise. Nearly all courts and commissions report their award in an eminent-domain case without indicating whether they would have allowed more or less as a value for rate-making purposes.

Market Values of Outstanding Securities as Evidence of the Value of the Condemned Utility Properties.

Closely related to the use of capitalized earning power as a measure of value is the use of the market prices of outstanding securities. The

[84] P.U.R. 1916 F, 593 (Calif. R.R. Comm.).

sum total of these prices might be assumed to reflect the market estimate of the prospective net earnings of the business and might therefore be taken as a rough index of the price at which the whole property could be sold as between a "willing buyer" and a "willing seller." In an earlier chapter we discussed the relationship between the value of an entire business enterprise and the market prices of the securities issued by that enterprise.[85] The courts have generally recognized both the relationship and the distinction; but in recent years they have been prone to overemphasize the distinction. In utility condemnations, the usual rule in eminent domain is adhered to, namely, that the taking of the "property" does not mean a taking of the securities and that the value of the former is not the same thing as the value of the latter.

But it has been held that evidence of security prices is admissible as a factor to be "considered," except perhaps when peculiar conditions render these prices unreliable as measures of value. The paucity of recent cases in point is perhaps due to the growth of the large holding-company systems, with the result that the condemned plants have formed only a small part of the enterprise whose securities are held by the public.

The fact that, in practice, both earnings and security values are usually given but minor weight in utility condemnations, and that replacement-cost estimates are given dominant weight, means that in general the owners of unprofitable utilities will be overindemnified for their losses and that owners of unusually prosperous utilities may be somewhat underindemnified. The proverbial liberality of awards in eminent domain, however, gives more point to the first statement than to the second. In view of this situation, the thought suggests itself that states or municipalities which desire to expropriate a private-utility plant might do well to condemn the securities of the owning company rather than to condemn the property itself, especially if the company's earning prospects have been so poor that the securities have been quoted at prices far below book values or structural costs. A precedent for this procedure may be found in the acquisition by the Canadian government, under an arbitration agreement, of control of the Grand Trunk Railway system on far more favorable terms than would probably have been upheld had the right of way been condemned.[86] An American precedent may also be found in *Matter of Morris Canal & Banking Co.*,[87] where the state of New Jersey expro-

[85] *Supra* pp. 244–249.
[86] See *supra* p. 151.
[87] 104 N.J.L. 526, 141 Atl. 784 (1928).

priated the securities of the canal company. It was held in this case that compensation should be based on the *market value* of the securities rather than on the value of the property owned by the company.

This possible means of escape from the prevailing tendency of American courts to base awards on replacement cost of structures even though the investment value of the enterprise is far below this cost, is well worth close attention.[88] But the attempt to make widespread use of it is sure to raise serious difficulties. In the first place, cities, or even larger government bodies like the Tennessee Valley Authority, seldom have the desire or the legal power to take over the entire property of any one utility company. Yet they would be forced to do just this if they were to condemn the securities. In the second place, the use of market value or market price as a basis of appraisal would be interfered with by the fact that, as soon as the prospective condemnation becomes known, security quotations would be influenced thereby and would therefore properly be disqualified as a measure of "fair market value." In the third place, most of the stocks of utility operating companies are so closely held by holding companies that a market value can hardly be legally established by resort to recent actual sales. If the stocks were inactive, the courts would doubtless follow their usual practice of requiring their "fair market value" to be determined by reference to the "fair market value" of the underlying properties, a procedure which would raise anew the very difficulties that might seem to be avoided by a condemnation of the securities.

Summary of Possible Distinctions between Value for Rate Making and Value for Condemnation.

We may summarize as follows the important apparent distinctions between value as a measure of just compensation and value as a basis of rate control:

1. Some dicta suggest that the property for which compensation must be paid in a condemnation case includes more than the property that must be included in the rate base. Specifically, allowance for franchise value is generally thought to be required in a condemnation case, but not in a rate case. The distinction, however, is now of doubtful import. The allowances made for going-concern value in effect

[88] But see a dictum to the effect that a statute empowering a municipality to acquire a utility plant by a condemnation of the company's stock would be unconstitutional. State ex rel. Cranfill v. Smith, 330 Mo. 252, 48 S.W. 891 (1932). However, the cases cited in 66 A.L.R. 1568 and 81 A.L.R. 1071 show that the weight of authority upholds the constitutionality of a condemnation of the capital stock of a utility company. Most of these cases upheld the condemnation of minority stockholdings.

supersede the older allowances for franchise value and for good will in both types of valuation.

2. In eminent domain, the courts have repeatedly said that *market value* is the desideratum, thereby implying that the property should be valued at the price at which it could be sold, or at least at such a price as investors would be justified in paying for the property in view of its potentiality for making profits. In rate making, the United States Supreme Court has never identified "fair value" with market value and has often come close to identifying "fair value" with some form of cost—actual cost or reproduction cost. But in practice, the courts and the commissions have usually given primary weight to cost estimates even in condemnation cases, so that this distinction has been pretty well disregarded.

3. Realized earnings have been held to constitute acceptable evidence of value in purchase cases but not in most rate cases. But courts and commissions have usually refused to give much weight to capitalized earnings, although they have "considered" the earning power of the utility in making additions to (and occasionally in making subtractions from) the so-called structural value of the physical plant.

4. In condemnation cases, less weight has been given to the original cost of constructing the physical plant, and more weight has been given to reproduction cost, than has been true of many rate cases. Even in the former situation original cost comes in for formal consideration, except, perhaps, where the property was constructed under very different price conditions from those now prevailing. But it is generally given weight only as a check on the accuracy of the estimates of current replacement cost. In many rate cases, on the other hand, original cost has influenced the tribunal to a far greater extent than would be justified on the theory that it is accepted merely as a check upon opinion estimates of replacement cost.

Conclusions of Chapter.

Enough has been said in this summary chapter to indicate that the uniformity with which the law of eminent domain declares "the value of the property taken" to be the measure of "just compensation" is a uniformity of phrase rather than of standard. Almost infinite diversity of standard has resulted from the intermingling of various judicial concepts of "property," of a "taking" as distinct from a mere injury, and of "value."

Most courts say that "value" means market value in the usual condemnation case, and a few courts (including the Supreme Court) have implied that this is the universal meaning. But the definitions

and interpretations of market value are vague and conflicting. There is no agreement as to whether the owner himself shall be considered as a hypothetical bidder or whether the purchase must be assumed to be made by some other buyer. Market value and *not* value to the taker is the declared measure of compensation; yet the question whether or when the taker's peculiar use for the property shall be taken into account has not been clearly settled. The property must be valued as of the date of valuation; yet some cases propose to disregard the "abnormal" prices of a current depression in favor of a "reasonable" or "real" market value.

Some support can be found for the hypothesis that the courts regard value to the owner as the real objective, and that they talk about market value because they are loath frankly to adopt a purely subjective measure of compensation. Evidence pointing in this direction is the free interpretation of market value so as to permit the assumption of a mythical "willing buyer" whose need for the property is the same as the owner's, together with the abandonment of the market-value test where the property is deemed to "have no market value." But conflicting indications can also be found in the refusal of some courts to consider any but flesh-and-blood buyers, in the rules excluding allowances for consequential damages resulting from the owner's necessity of moving to other premises, and in the proneness of some courts to admit value to the taker by the back door, as an "element" of market value.

The foregoing statements should not be taken to imply a belief on our part that a uniform measure of compensation, or even a uniform meaning of value, should be adhered to in condemnation cases. Clarified distinctions rather than universal rules may be called for. We venture the following suggestions looking toward that end.

As the recognized objective of the award is to compensate the owner for a loss, not to permit him a benefit from the public improvement, all claims for a value based on the adaptability of the property to the special needs of the taker should be rigidly rejected. Moreover, all measurable enhancement in the value of the property because of the benefits anticipated from the improvement should be disregarded.

Market value should be construed to mean the price at which the owner could have sold the property to some other buyer, had the improvement not been undertaken. The notion of a mythical "willing buyer" should not be invoked to bridge the gap between sale value and value to the owner.

Where there is good evidence that the price at which the property could have been sold does not even approximate the special value of

the property to its owner, this latter value should be frankly accepted as the measure of compensation.[89] But the difficulty of estimating value to the owner justifies a court in placing a strong burden of proof on the claimant as to any excess of this value over market value.

The rulings of the courts against allowances for such consequential damages as loss of business good will and costs of moving to other premises, while they may be justified because of practical difficulties of measurement, should be recognized as derogations from an allowance of the full value of the property to its owner.

The prevailing doctrine in partial-taking cases, whereby the award is based on "value of the part taken plus damages to remainder" should be superseded by the minority doctrine, basing the award on the "difference between the value of the entire property before and after the taking."

Important as is the construction placed by the courts on the phrase "value of the property," it is of minor consequence as compared to the procedure of the trial, the bias of the tribunal, and the treatment of the evidence. The scandalous overvaluations that were described in the Wallstein report on New York City condemnations[90] were due, not primarily to unsound or ambiguous definitions of value, but to the testimony of fancy values by paid witnesses, to the unfamiliarity of the courts with modern appraisal technique and real-estate markets, and to unfortunate restrictions on the admissibility of actual sales of similar properties as evidence of value.

[89] Even when qualified by rules excluding allowance for sentimental value and for certain incidental losses, the standard of value to the owner has practical objections which may make its adoption unwise unless and until appraisals of condemned property are made by independent experts, subject to court review, rather than by an inexpert judge or jury. The primary objection is that most tribunals are biased in favor of the owners in condemnation cases and are hence likely greatly to overestimate the worth of the property to its owner. To some extent, though altogether inadequately, this danger is guarded against by the usual rule requiring an appraisal at market value—a rule which, while seldom adhered to with rigor, nevertheless has a somewhat restricting influence on the judge or jury. Perhaps this point was in the minds of a British committee on the law of compulsory acquisition, which recommended the adoption of the American standard of "market value as between a willing seller and a willing buyer" (with "fair compensation" for consequential injuries) on the ground that the more usual British alternative of "full compensation," combined with the standard of "value to the owner," "has led to the owner being unduly given the benefit of the doubt." Ministry of Reconstruction: *Second Report of the Committee Dealing with the Law and Practice Relating to the Acquisition and Valuation of Land for Public Purposes* (London, 1918) p. 8. In short, the committee took the position that bad doctrinal law may be a necessary offset to bad trial procedure.

[90] *Supra* note 19.

CHAPTER XVII

VALUATION FOR TAX PURPOSES: THE GENERAL PROPERTY TAX*

VALUATION FOR TAX PURPOSES

Common to the legal appraisals treated in the four previous chapters is an objective which sets the starting point for an inquiry as to the definition and measurement of property value—the objective of indemnity. What the property is "worth" must there be determined in the light of the purpose of the lawsuit, which is to fix a cash payment that will recompense the owner, in whole or in part, for the loss of his valued possession.

When we turn to the valuations for tax purposes, a different situation is presented. No longer is the owner claiming a recompense for the loss of his property; on the contrary, he is being compelled to contribute to the government treasury, in an amount which, for some reason, is measured by an appraisal of his wealth, or of a specific portion of his wealth. The very meaning of "value of the property," no less than the practical technique of its measurement, now becomes dependent on issues that fall within the province of fiscal theory and tax administration.

In canvassing the literature of public finance, one looks in vain for any master principle of tax apportionment which can take the place of the indemnity principle under the laws of damages and eminent domain, as the chief clue to the proper meaning of "value." Instead, one finds a variety of equally basic principles of "just taxation," most of which are in conflict with each other, and no one of which, taken alone, would clearly settle disputes as to the ideal basis of valuation. This welter of ambiguous and conflicting fiscal principles exists even with respect to a single type of tax, like the general property tax or the inheritance tax. But the confusion is multiplied by the coexistence of many different types of taxation, each of which has its peculiar philosophy

* Based on studies by Simon H. Rifkind, C.S.S. Epstein, J. L. Weiner, and Morton Liftin. The major portion of this chapter is reprinted from our earlier article on "The Valuation of Real Estate for Tax Purposes," 34 *Col. L. Rev.* 1397 (1934). A recent study by Joseph D. Silverherz, The Assessment of Real Property in the United States, Special Report of the State Tax Commission (Albany, N.Y., 1936), appears too late for our use.

and administrative technique, and each of which makes different uses of a valuation. Obviously, therefore, it would be vain to seek any general concept of "value for tax purposes," applicable alike to the general property tax and the inheritance tax, or to a capital-value tax and an income tax. Indeed, there cannot even be any such thing as "value for income-tax purposes," or "value for general-property-tax purposes," valid under all circumstances. The subject must be divided and subdivided by reference to the particular uses of the valuation and to the specific types of property.

The embarrassingly wide scope of our study has prevented us from treating all forms of taxation which call for appraisal. Omitting the protective tariff, the "special assessment" of real estate, and various excise taxes (in all of which there is a paucity of case law so far as concerns valuation problems), we have chosen three types of taxation measured directly by property value (the general property tax, the special taxes on the values of corporate enterprises, the estate and inheritance taxes), and one tax based on individual or corporate income (the Federal income tax). The major division is between the three capital-value taxes and the income tax; and this cleavage is so important, from the standpoint of appraisal theory, that we have placed the income-tax chapters in a different part of this treatise, along with other chapters on the valuation of property for income-measurement purposes. For reasons to be explained in Chap. XXVI, the valuation of property, as a mere first step in arriving at annual income, proceeds on principles quite different from those that are applicable to other types of appraisal.

VALUATION UNDER THE GENERAL PROPERTY TAX

This chapter and the one immediately following it discuss two related types of taxes, the so-called general property tax, and the various taxes on the capital values of going concerns. The former is illustrated by the familiar annual assessment of real property, and the latter by a state or Federal capital-stock tax or by a special franchise tax. Both types have two features in common, in that they involve periodic reappraisals (unlike the inheritance tax), and in that they purport to use the capital value of the property as the tax base (unlike an income tax, or a tax on rental value). But they differ materially in their concepts of the property subject to taxation, the general property tax being imposed largely on tangible objects of wealth with a fixed geographic location, whereas the going-concern taxes look to entire business enterprises as the subject of taxation. This distinction, to be sure, is not sharply drawn, and many taxes represent confused

transitions from a tax on physical things to a tax on incorporeal enterprises. Indeed, the frog of a going-concern tax usually has the tadpole's tail of the old-fashioned property tax, and the converse situation is even more clearly true. But just because the distinction is not sharp, its presence requires all the more emphasis.

Were it not for a short section on the assessment of personal property, this chapter might best be called "The Ad Valorem Real Estate Tax," since the general property tax has become so largely a real-estate tax. But it would still be necessary to distinguish between the appraisal of realty under a tax which makes this very property the subject of assessment, and the valuation of the same property as a mere asset of an entire business enterprise. Under a capital-stock tax, for example, the courts may permit assessors to consider the value of a factory building as "evidence" of the value of the business located on the premises. Yet the principles of valuation may differ markedly from those that would be accepted were the factory building to be assessed directly.

I. The Theory of the General Property Tax as Affecting the Basis of Valuation.

Since this study is confined to the appraisal aspects of taxation and is further restricted to those problems of valuation that frequently get into court, it cannot present that broad survey of tax theory which is essential to a full understanding even of the issues now to be discussed. Fortunately, this omission is made good by an extensive recent literature on public finance, familiarity with which will be assumed for the purposes of the present chapter.[1] But it is necessary briefly to discuss the theory of the tax as bearing on the definition and measurement of assessed value. Only by considering why the *value* of a house or a factory is supposed to serve as a better tax base than, say, the number of rooms which it contains or the amount of paint that is placed on its outer walls, can one find any basis on which to decide such nicer questions as whether the property should be "valued" at original cost, or at replacement cost, or at market value, or at some still different figure popularly supposed to represent "value."

There are two traditional theories of tax apportionment from which an inference might be drawn as to how much of the total burden of government should be placed upon Smith and how much should be

[1] See, for example, E.R.A. Seligman, *Essays in Taxation* (10th ed., New York, 1928); Harley L. Lutz, *Public Finance* (2d ed., New York, 1929); William J. Schultz, *American Public Finance and Taxation* (rev. ed., New York, 1932); Clyde L. King, *Public Finance* (New York, 1935).

placed upon Jones. According to the "ability-to-pay" theory, the more prosperous man should pay the higher tax, quite without reference to the question whether he has derived more benefit from the services of government than has the poorer man. According to the "benefit" theory, the larger beneficiary from all the various public services—police and fire protection, legal safeguards, use of streets, etc.—should pay the higher tax, even though the lesser beneficiary may be quite as able to contribute to the community chest. But the benefit theory itself is a confusing name for two sub-theories, the first of which means what the words say that it means, while the second means that taxpayers should contribute in proportion to the costs or losses that they and their property impose on the government or even on the whole community.

In an earlier period, most writers in public finance praised or blamed the general property tax by reference to the canon of ability to pay. The defense was based on the assumption that the man with more valuable property can afford to pay a higher tax; and the attack was based largely on a denial that such an assumption is valid.[2] Even when the tax became, in effect, a tax on real estate, its merits were still debated largely on this issue. Those who supported the tax would then argue that there is a crude correlation between the amount of real property that any individual owns and the amount of total wealth that he possesses. Rich men are likely to own expensive mansions; poor men are likely to own (or rent) mere cottages.

But within recent years the ability doctrine, when adduced in support of a general property tax, has received such smashing blows from students of public finance that it cannot be taken seriously save with respect to very limited types of property—notably, private residences. Some of these blows, to be sure, may perhaps be parried. It has been said, for example, that annual income rather than capital wealth is the better index of relative taxpaying ability; but to this point the argument is made that a combination of the two indices is better than either alone, since the rich man who has no current income should not utterly escape taxation. It has also been said that a general property tax, in practice, is a tax merely on tangibles, especially on real property, and that the value of an individual's tangible property is no longer an acceptable index of his total wealth. Here again the reply is made that supplementary taxes, like the business taxes, should

[2] Also in part on the contention that appraisers cannot in practice determine the true value of the property and are therefore forced to resort to arbitrary assessments.

take care of the intangibles, leaving the general property tax in charge of the more solid properties.

Other hurdles, however, are not so easily jumped, not even on paper. When the ability-to-pay doctrine is invoked in defense of property taxes, the defender almost invariably has in mind the property rights of flesh-and-blood individuals who may be "hurt" by a high tax, or who can "afford" to contribute heavily to the government. Yet a large part of the property that is subject to assessment is under the titular ownership of corporations. While one may still speak figuratively of the "burden" of taxation on a corporation, or refer to the fact that the United States Steel Corporation can "afford" to pay a higher tax than can Smith, Jones and Company, Inc., the owner of a sandwich shop, the meaning of this language here becomes very indefinite—so much so as to throw doubt on any inferences as to a correlation between the relative taxpaying abilities of two corporations and the values of their assets.

The difficulty of defending the general property tax on the ability principle is greatly enhanced by the fact that this tax recognizes comparatively few divisions of ownership interests in tangible objects. Land is taxed at its value "as land," without reference to the question whether it is subject to a mortgage. Neither a corporate owner nor an individual owner may deduct his debts in order to arrive at a statement of *net* wealth subject to taxation. Indeed, the net-wealth idea is a characteristic of corporation taxes as distinct from the general property tax, and it makes theformer taxes easier to defendon the ability doctrine of tax apportionment. What reason is there to suppose that the value of a house worth $10,000, but subject to a mortgage of $9,000, measures even crudely the taxpaying ability of the owner of the equity?

So obviously fatal have been these objections to the general property tax when supported entirely by the doctrine of ability to pay, that the sponsors of this tax and of the kindred real-estate taxes have been obliged to resort to other theories of taxation for their defense. The one that concerns us most clearly, because of its important implications as to the proper basis of appraisal, is the second version of the benefit theory. Under this principle, a tax is levied on a factory, or a homestead, or a street-railway plant, not because any one of these properties is assumed to indicate taxpaying capacity, but rather because its existence and operation impose on the government the necessity of raising additional revenues. Part of these revenues must be raised in order to protect the very property that is being taxed; but another part must be raised in order to protect the community against the harm

that this property would otherwise do to other property or to other individuals.[3]

It is easy to pick serious flaws in this alternative defense of the general property tax or of the more restricted taxes on tangibles or on real estate. But the tax experts who find these flaws fatal, as they often find the arguments based on the doctrine of ability to pay, are forced to conclude that ad valorem property taxes should be abolished, which indeed is precisely what some of them have concluded. More cautious critics of our tax systems cling at least to the real-estate end of the general property tax and defend it by reference sometimes to the one doctrine, sometimes to the other. With private residences the ability-to-pay theory is usually stressed; with business properties, especially those owned by corporations, the "benefit" or "burden-on-the-community" doctrine is more likely to be emphasized.[4]

In addition to the two traditional theories of tax apportionment mentioned above—the ability theory and the benefit theory—the textbooks in public finance raise a new issue in the form of the "capitalization" theory[5] of the incidence of real-estate taxation. The point is made that, when the amount of the annual real-estate tax is once fixed, it operates to reduce the capital value of the property by an amount measured by the capitalized adverse value of the annual tax liability. In consequence, if the property is sold after the initial imposition of the tax, the purchaser buys it, in effect, tax free. The entire burden of the prospective series of taxes falls back upon the unlucky former owner, in the form of an abatement of the price at which he might otherwise have sold his property. Writers have not been in agreement

[3] The literature on taxation has largely neglected this latter point. That is, it has assumed that property should bear the burden of those government revenues designed to benefit that very property, overlooking the argument that property should also bear the burden of protecting other people *against* the property in question.

[4] The benefit theory of taxation as a defense of the real-estate tax has been emphasized by Dr. Robert Murray Haig and his associates in their reports to the New York State Commission for the Revision of the Tax Laws. See the Commission's Report submitted Feb. 15, 1932, Part II and Memorandum 5. The staff studies indicated that, in most New York State communities, somewhat over 50 per cent of the revenues raised by the real-estate taxes were expended for government services directly benefiting the taxed properties. It was largely because of their insistence on the benefit principle of taxation that two of the commissioners, Messrs. Seligman and Strauss, dissented from the majority, which had urged a very drastic reduction in real-estate taxes on the ground that this type of property was being "disproportionately" burdened.

[5] See E. R. A. Seligman, *The Shifting and Incidence of Taxation* (4th ed., New York, 1921); report of R. M. Haig and E. H. Spengler, *supra* note 4, at p. 127, and Memorandum 4.

as to the bearing of this supposed phenomenon of "tax capitalization" on the philosophy and administration of the tax. But some of them have drawn the conclusion that an "excessive" tax on a particular property, or an "excessive" level of taxes against all properties, after having been imposed for a considerable period of time, should not be reduced, since the advantage of the reduction would constitute a mere windfall to subsequent purchasers. It would seem to follow that, only by occasionally raising the tax in such a way as painfully to surprise the real-estate market, could the government succeed in throwing the burden of a real-estate tax on transferees.

Finally, one must mention the single-tax theory, according to which all improvements to land should be tax exempt, while vacant-land values should be brought down to zero by the collection of taxes equal to the entire annual rent value of the land. The general philosophy of this tax is too well known to require restatement. It is not pertinent to a study of assessments under the general property tax except in so far as it has had a vague influence, in some communities, in the direction of relatively high assessments of vacant land.

With this brief introduction to the philosophy of the general property tax, in its modern form of an unclassified realty tax, let us turn to the question of the proper basis of assessment. Chief interest centers in the implications of the ability theory and of the second version of the benefit theory.

Under the ability theory, that principle of appraisal would seem to be applicable which makes the assessed "value of the property" the best measure of the owner's economic wealth and hence of his ability to contribute to the community chest. Original cost of the property, and also replacement cost (even with conventional deductions for depreciation) would seem to be disqualified, save as a possible clue to the present worth of the property. "Intrinsic value," construed as the worth of the property itself, without reference to its functional usefulness to the particular owner, is utterly meaningless here, as it is in a valuation for any other purpose.

A nicer question of choice concerns the alternatives of market value and value to the owner, where the property is demonstrably worth far more to its present owner than the price at which it could be sold to anyone else. Some writers in finance, while conceding that value to the owner may be the ideal basis of valuation under the laws of damages and of eminent domain, have insisted that, for tax purposes, market value in its literal sense of realization price should always be adopted. This position is plausible, though not conclusive, in inheritance taxation, where the tax is generally paid by the sale of a part of the very

property in question. But it hardly applies to the general property tax, where the taxpayer's usual procedure is to pay the tax from his current income rather than by liquidation.

The literal adoption of a market-value rule would seem to do gross injustice by hitting only those taxpayers whose property happens to take marketable form. Consider an extravagant mansion, unsalable because it is now owned by the one man in the community who is wealthy enough to indulge in such a luxury; or a factory whose very value to its owner consists in a special design which makes it unsalable. If the property were appraised at its market value, in the sense of the price for which the owner could actually sell it, it would be almost tax exempt. Of course, the appraiser may invoke some concept of a "fair market value," defined as a price at which the property might be sold by a fictitious willing seller to a fictitious willing buyer. But such a concept, though traditional in the law, suggests either an utterly meaningless compromise between the owner's withholding price and a buyer's bidding price, or else a camouflaged standard of value to the owner.

We conclude that value to the owner has much the better claim to acceptance than market value, although on grounds quite different from those which support the use of the same standard under the laws of indemnity. But even value to the owner is not *always* an acceptable basis of real-estate assessment under the ability doctrine. In the first place, exception must be made of the sentimental value of a homestead—a value which bears no measurable relation to the economic power of the property owner. In the second place, a far more serious exception must be made with respect to real estate, such as an unmarketable factory, which cannot be intelligently valued save as a part of an entire going concern. Here, what the factory is worth to its owner must mean the adverse value of the loss that would befall the going concern, were it to be deprived of this unit of its tangible property. This loss would include, not merely cost of replacement, but also all of those "incidental damages" involved in relocating the business elsewhere. Valued separately in this way, ten factories of a single, organic business might be appraised, in the aggregate, at far more than the entire business is worth.

As a matter of fact, an intelligent assessment of unmarketable business real estate, under the ability-to-pay doctrine, is simply impossible. The only significant value is the value of the entire *business* as a going concern; but this value cannot be reached by the general property tax or by any tax which singles out real estate or tangibles to the exclusion of other property.

Let us now turn to the two versions of the benefit theory for such light as they may throw on proper methods of assessment. Here the question becomes, What measures of value are most closely correlated with the benefits received by the owner from the services of government, or with the costs and injuries imposed upon the community by the presence and operation of the property?

But the question cannot be answered with confidence, since the correlation between benefits received or costs imposed on the one hand, and property values on the other hand, is very remote. The whole assumption of the tax, that because property *A* is worth ten times as much as property *B*, therefore its owner is receiving ten times as much benefit from government, or is imposing ten times as much cost upon the community, is so flimsy that it will furnish but little basis for a nicer inference as to the precise meaning of "worth of the property." Within wide limits, any basis of valuation is as reasonable—that is, as unreasonable—as any other.

Nevertheless, so long as a tax system as crude as the unclassified real-estate tax persists, there is something to be said for an interpretation of the "value" of improvements to mean estimated reproduction costs, quite without reference to their commercial value—in short, without reference to "value" in any accurate sense of the term. The defense of this method of assessment consists in the likelihood that the *costliness* of structures is a more reliable index of the burden imposed upon the community in protecting the property, and in safeguarding other people from the bad influences of this property, than is commercial value. A great railroad station imposes on a local government far more outlays than does a small house—not because the station is more valuable to the railway company than is the house to the householder, but because it is a more formidable type of property. The station would impose this heavy burden even if railway traffic should become so unprofitable that earning power, and hence commercial value, were very slight.[6]

In practice, assessments are frequently based on crude estimates of replacement costs minus an allowance for depreciation. But if the point made in the previous paragraph has any merit, it would suggest that no allowance should be made for depreciation. A depreciated building is ordinarily a greater liability to the community than an

[6] Compare the following comments by Harley L. Lutz: "Very often a bankrupt concern is one which is causing a larger outlay on the part of government than the prosperous concern. They are in the courts more frequently. They have fire hazards which are for moral reasons greater than those of the prosperous concerns. There are police and other services conferred upon them by government just as generously as if they were making large and handsome profits." 26 Nat. Tax Assn. Proc. 81 (1934).

undepreciated one; and the owner of an obsolescent structure might fairly be required to pay even a *higher* tax than does the owner of a modern structure.

Of course, no amount of tinkering with the principles of assessment can remove the fundamental defects of the general property tax. Indeed, it is necessary to catch at straws in order to justify any one basis of assessment as preferable to any other basis. But the attempt to rationalize assessment procedure, as we have done in this chapter, may serve one good purpose—that of calling attention to the necessity of solving the problem by abandoning an outmoded form of tax. A "scientific general property" tax is a term as self-contradictory as is the term "scientific protective tariff."

A word may now be said about the bearing of the "capitalization theory" on the proper mode of tax assessment. But our comments will be inconclusive in the absence of a much closer analysis of this theory than has yet been made in the literature of public finance. If it is true, as assumed by the simpler forms of the theory, that when the annual levies against real estate have long been established and are expected to endure, subsequent purchasers buy the properties, in effect, tax free, then there is a strong case in favor of the maintenance of old assessments and for a refusal on the part of assessors and courts to reconsider these assessments even though they are now recognized as having been erroneous. We have here a special version of the old canon that "the best tax is an old tax." The case is stronger in those communities in which real estate changes hands rapidly, as well as with respect to real property held by corporations whose shares have been subject to much trading. In both of these instances, the injustice done through the initial mal-assessments is uncurable, since the persons who suffered this injustice—the original holders of the land or of the corporate shares—will not be helped by a reappraisal of the property unless they happen still to have an interest in the property.

II. Statutory and Judicial Definitions of Value.

Those who are familiar with the distinction, drawn by modern writers on jurisprudence, between a traditional definition of a legal concept and a functional definition, will not be surprised to find that few of the reported opinions in tax-assessment suits treat the subject from the standpoint of the preceding section. Instead of building up their value concepts by reference to the economic philosophy of the tax, they generally start with the form of words used in the pertinent statute, such as a declaration that the property must be assessed at its "fair market value" or at its "true cash value," and they then rely

largely on the traditions of earlier case law, both within and without the field of taxation, as a basis for settling disputes as to what these terms mean and as to how the amount of the required value shall be measured.

Statutory and Constitutional Definitions.

The general property tax is always the subject of specific state statute, and sometimes also of state constitutional provision. Yet in deciding what meaning to give to the word "value" as a basis of taxation, the courts have had little help from the statutory definitions. Often, to be sure, some qualifying adjective appears in the statute or constitution, as a prefix to the word "value." But these adjectives, vague at best, are simply borrowed from previous judicial opinions. The most frequently used phrases are "true cash value," "fair cash value," "fair market value," "true value," "full value," "fair value," "actual value."[7] As a rule the courts read no significance into these terms which they would not find in the unadorned word "value," and they have generally declined to draw any distinction between the different phrases.

It would be going too far, however, to assume that the statutory definitions of value have been utterly without influence on judicial rulings. On at least two important issues their implications have sometimes been accorded considerable weight: in their distinction or lack of distinction (*a*) between current market price and "normal" value, and (*b*) between *any* kind of a market value and value to the owner. The first of these issues becomes acute in a business depression, when taxpayers complain that their properties are assessed at more than the prices at which they could presently be sold; the second presents itself even in a period of "normal" business, when taxpayers offer to prove that their properties are unsalable because they are especially designed for their own uses.

Value Usually Construed to Mean Market Value.

Many definitions of value will be turned up by an assiduous search through the court reports in tax cases—definitions ranging from such simple vacuity as "the sum of the estimable qualities of a thing" to such sonorous bombast as "a recognizable pecuniary value inherent in itself, and not enhanced or diminished according to the person who owns or uses it."[8] These are exceptions, however, to a well-standardized

[7] National Industrial Conference Board, *State and Local Taxation of Property* (1930), Table 2, pp. 96–102.

[8] See Perry v. City of Big Rapids, 67 Mich. 146 at 147, 34 N.W. 530 (1887). See also Carreker v. Walton, 47 Ga. 394 (1872).

formula which appears in most of the opinions. The formula, which has the sanctity both of great age and of constant repetition, is that value means market value, which in turn is defined in some such words as "the price which the property would bring in an open market on a free, not forced sale between a willing buyer and a willing seller."[9] A variation in the form of expression is occasionally found, to the effect that value is the amount which would be received for the property by a creditor from a solvent debtor in payment of an honest debt.[10] In short, the doctrinal law of taxation accepts market value as the standard applicable to most types of property but purports to define it by a form of words that has no definite meaning.

Value Distinguished from Actual Cost and from Replacement Cost.

The doctrine is universal in tax law that value is not a synonym either for actual cost or for replacement cost, depreciated or undepreciated. Either of these cost items may be accepted by the tax officials as *evidence* of value and may even be taken as the best measure of value in a given instance. But in many cases an assessment based on cost has been upset by a court on the ground that the property was not worth its cost.

For reasons already given, this doctrine, supported by statute, whereby the *cost* of property may not be brought into the picture save under a ruling on evidence, would seem to imply that the legal philosophy of a property tax is based on the ability-to-pay principle of tax apportionment[11] and not on a benefit principle. And the implication is probably warranted in so far as the legislatures and the courts may be said to have any fiscal philosophy in mind. But when tax assessors or judges discuss assessment practice outside of the courtroom, free from the inhibitions of doctrinal law, they are likely to invoke a benefit principle in defense of appraisals based on the physical attributes of the property—its cost, or even its mere bigness—even though the commercial value of the land or structures is concededly very slight or doubtful.

[9] See People ex rel. Sebring v. Dowd, 206 App. Div. 727 at 728, 200 N.Y. Supp. 500 at 501 (4th Dept., 1923); *cf.* National Bank v. City Council, 136 Iowa 203 at 209, 112 N.W. 829 at 832; Long Dock Co. v. State Board, 78 N.J.L. 44 at 53, 73 Atl. 53 at 57 (1909). As to a more desirable type of definition from the standpoint of the assessor, see Spring, "Some Difficulties from Statutory Definitions of Valuation for Taxation Purposes," 12 *Nat. Tax Assn. Bull.* 174 (1927).

[10] *Cf.* Winnepiseogee Lake Cotton & Woolen Mfg. Co. v. Town of Gilford, 67 N.H. 514 at 517, 35 Atl. 945 at 946 (1894). This variation is perhaps induced by a desire to take care of the situation where a ready market is lacking for a particular kind of property.

[11] See Northern Pacific Ry. v. Adams County, 1 F. Supp. 163 at 176 (E.D Wash., 1932).

In all probability this same point of view has its influence in less freely expressed form when the assessors and the courts perform their official duties of weighing replacement costs against other proposed "measures of value."

"Fair Market Value" versus Current Market Price: The Depression Cases.

A doctrinal correspondence between tax law and the law of eminent domain or of damages is to be found in the distinction between market value as a "fair market value" and the abnormally low prices at which properties are sold at forced sales. The "willing buyer, willing seller" phrase is designed to guard against the use of the latter standard of value, and conversely it may preclude an assessment of real estate at inflated boom prices.

Even in the formal law, however, there is serious doubt as to the precise nature of this distinction between "fair market value" or "true value" on the one hand, and current realization price on the other. Narrowly interpreted, it means merely that the property must be valued at the price at which it could actually be sold *under prevailing market conditions* by an owner who has a decent time to shop for a buyer and to carry on negotiations. It would therefore imply a rule of evidence that current sales of real property must be accepted as representing values unless they were made by necessitous sellers without benefit of fair negotiation. But more broadly interpreted, it may mean that the value of the property is, by very definition, a hypothetical value such as would be realized in a *normal* market. When so construed, the assessor may ignore even the non-forced sales of abnormal times in favor of such prices as may be supposed to prevail in normal times.

The pending business depression has raised this issue in an acute form, with respect to tax assessments no less than to value for condemnation and other legal purposes. In taxation, the owners demand the low values against which they themselves protest in the indemnity cases. The taxing authorities have naturally tended to compromise, with the result that assessments have been reduced during the last few years, though not in the degree to which market prices have fallen. Some of the officials have defended their relatively small reductions by invoking the concept of normal value without distinguishing it clearly from the traditional concept of a non-forced sale price.[12]

[12] Thus Mr. William Stanley Miller, Acting President of the New York City Department of Taxes and Assessment, explained as follows the refusal of the city to cut its assessments for 1935 by more than about $450,000,000 from the total of approximately 16½ billions for the previous year: "We are keenly appreciative of the general burden of taxation, Federal, state and municipal, and have full

It is too early in the legal history of the pending business depression to determine the extent to which the concept of "normal value" will influence the courts. But from the handful of opinions already reported in taxpayers' appeals, it is apparent that the influence will be material. All of the cases seem to agree that the depression has adversely affected "real values" as well as current market prices; their disagreement lies in the extent to which they accept the assessors' contentions that the effect on the latter is much more marked than the effect on the former.

We may note first three Kentucky cases[13] which tend to belittle, though not completely to deny, the distinction between value and current price. These were appeals from tax assessments for 1929 and 1930 by enterprises of an industry that had suffered a serious depression since 1920. In the *Knott County* case a member of the board of supervisors had testified as follows:

> We didn't attempt to fix the taxable values of these lands under the present condition that the country is in now. Our values were fixed at what this property would be worth under normal conditions when there would be a market for it and when it would sell.[14]

The admission proved fatal to the assessment. Pointing out that the state constitution and statute required the taxation of the property at "its fair cash value estimated at the price it would bring at a fair voluntary sale," the court said that the property must therefore be assessed "at its present value rather than its ultimate productive worth."[15] The same view was expressed in the *Atlantic States Coal* case, where the court said:

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knowledge of the struggle of real-property owners to retain their holdings, but we trust that property owners will realize that assessed valuations are fixed according to law at the true value of their property under normal conditions. We again stress 'normal conditions.' Distress sales, forced sales under bids under foreclosure cannot be considered normal and hence deemed an accurate criterion of value. The price at which many owners would willingly dispose of their property at this time is not a basis for fixing value, since often there is a need for ready cash or a desire to be rid of the responsibility of ownership which prompts a sale at any price, and that does not indicate true value under normal conditions." *New York Times*, Oct. 2, 1934, pp. 1, 15. The *Times* stated that this latest cut increased to over four billion dollars the total reductions made since the depression began.

[13] Kentucky River Coal Corp. v. Knott County, 245 Ky. 822, 54 S.W. (2d) 377 (1932); Atlantic States Coal Corp. v. Letcher County, 246 Ky. 549, 55 S.W. (2d) 409 (1932); Letcher County v. Kentucky River Coal Corp., 250 Ky. 7, 61 S.W. (2d) 891 (1933).

[14] 245 Ky. at 827, 54 S.W. (2d) at 379.

[15] *Ibid.* at 828, 54 S.W. (2d) at 379.

In fixing the value of property for taxing purposes, the criterion is, not what it may be worth at some future date nor what it may have been worth in the past, but what was its fair cash value on the date as of which it is assessed.[16]

A similar issue arose in Massachusetts as a result of a depression in the textile industry antedating the country-wide business depression of 1929. *Tremont & Suffolk Mills v. City of Lowell*[17] was an appeal from a refusal of the city assessors to abate the 1926 assessment of three cotton-textile mills of a company that had suffered serious financial reverses. The total assessment as of April, 1926, was $5,073,550. In December of that same year, all of the taxpayer's properties were sold to another textile company for $500,000. Shortly thereafter the purchaser resold two of the three divisions of real estate thus acquired and much machinery and mill equipment for $527,081.19, retaining, however, the third division of the real estate and the best machinery of the whole plant. The taxpayer's petition for an abatement was referred to a commissioner, who concluded that the original assessment was too high and proposed an assessment of $2,854,263.25. This report was accepted by the lower court. Both parties were dissatisfied with the rulings below, and the case was reported for determination by the Massachusetts Supreme Court, which held that no error was committed by the trial judge and affirmed the assessment. In defending this reported assessment, the commissioner said:

It is a matter of common knowledge that such textile mills or plants located in the principal textile communities of Massachusetts as have been sold or offered for sale since April, 1926, have sold for or are being offered at prices which approximate ten per cent of either their assessed or depreciated replacement values.

He urged, however, that such sales represent forced transactions, reflecting a depression psychology "of timidity if not of panic."[18]

In its opinion the higher court objected to the language of the commissioner's report which had invoked the concept of a "normal" or "intrinsic" value of physical property. On the other hand, it refused to accept the taxpayer's contention that the "fair cash value" which is required under the Massachusetts tax statute is a synonym for the "readily realizable cash sale value" which has sometimes been taken as

[16] 246 Ky. at 551–552, 55 S.W. (2d) at 409–410. In all three of these cases a reduced assessment was required, although the original assessments had been upheld by a lower court in two of the cases: Atlantic States Coal Corp. v. Letcher County; Kentucky River Coal Corp. v. Knott County, both *supra* note 13.

[17] 271 Mass. 1, 170 N.E. 819 (1930).

[18] *Ibid.*, at 18, 170 N.E. at 825.

a criterion of value under the Federal income-tax laws. To quote from the opinion:

It is the duty of the assessors within reasonable limits to seek light from every available source bearing on the "fair cash value" of all property to be assessed by them for purposes of taxation. . . . Periods of great general business depression actually affecting the cash which in exchange for the property a willing buyer would give and a willing seller take, not as a matter of fleeting fluctuation but of matured financial judgment covering a measurably substantial time, must be regarded by the assessors and reflected in the assessed valuation.[19]

Whatever construction may be placed on this judicial utterance, the actual decision of the case seems to represent a partial victory for the "normal-value" school of tax assessment. One can hardly read the opinion without reaching the conviction that the court was sustaining an assessment in excess of the price which an intelligent investor would have offered for the property in April, 1926.

Central Realty Co. v. Board of Equalization and Review,[20] decided by the West Virginia Supreme Court of Appeals, is in harmony with the Massachusetts decision. In attacking its assessment for 1930, the taxpayer presented witnesses whose low valuations were evidently influenced by the net income derived from the property and by the current market value of the company's outstanding stock. But the court upheld the assessment, under a statute calling for "true and actual value." Although the statute itself, as quoted by the court, identified this value with "the price for which such property would sell if voluntarily offered for sale by the owner thereof, upon such terms as such property . . . is usually sold,"[21] the court indicated that the rule should not "be strictly applied to any particular year in which property, due to depression and unhealthy business conditions, has no prospective buyer at any figure. . . . Values of real estate and fixtures thereon are more or less constant over a period of years."[22]

A similar distinction between *prices* that are volatile and *values* that are relatively stable was drawn by the Connecticut Supreme Court in upholding a contested assessment for 1932, in *Somers v. City of Meriden.*[23]

It was conceded on the trial that on October 1, 1932 the "market value" of the property was not ascertainable, owing to lack of "conditions in which

[19] *Ibid.*, at 18–19, 170 N.E. at 825.
[20] 110 W. Va. 437, 158 S.E. 537 (1931).
[21] *Ibid.* at 439, 158 S.E. at 538.
[22] *Ibid.*, at 440, 158 S.E. at 538.
[23] 119 Conn. 5, 174 Atl. 184 (1934)

there are, or have been, or will be within a reasonable time, willing sellers and able buyers of property like that to be assessed, and in which sales are or have been made, or may fairly be expected, in the usual and natural course of business." The plaintiff admits that, therefore, the valuation must be arrived at by some other method.[24]

The court then stated that the factors to be considered as affecting present value are actual rentals, income-producing capacity, average net income over a period of years, purchase price in 1926, improvements on the property, the size, location, and other particulars about the lot in question, and reproduction costs less allowances for depreciation and obsolescence.

As to the New York assessments, which have created much resentment in the real-estate world, no reported opinions raised by the business depression have been rendered by the Court of Appeals at the time of writing. The state tax law[25] declares that the assessments shall be based on "full value." But Sec. 889 of the Greater New York City charter, which governs the assessments in this metropolis, imposes on the assessors the duty of assessing each parcel of real estate at the amount for which it would sell "under ordinary circumstances." The phrase "under ordinary circumstances" may well have been intended merely to outlaw the consideration of forced sales by necessitous sellers and of hold-up sales to necessitous buyers. But the New York City Tax Department has taken the position that "ordinary circumstances" means "normal market conditions."[26]

Up to the time of writing, only one reported opinion seems to be concerned with this point: *People ex rel. Wagner v. Sexton*, decided by the Special Term of the Supreme Court.[27] But this opinion dodges the issue by viewing it merely as a problem in the law of evidence, whereas the real problem concerns the substantive law—the very meaning of "value," of which the "evidence" is probative. The contested assessment was that placed on the Lincoln Building property for 1933—$17,750,000, of which $8,000,000 represented land valuation. The taxpayer contended for an assessment not in excess of $12,039,283, and the court reduced the assessment to $16,800,000, allowing $7,800,000 for the land. After noting the requirement of the New York City charter as to a sale price "under ordinary circumstances," the court said:

[24] *Ibid.*, at 7–8, 174 Atl. at 185.

[25] N.Y. Tax Law (1909) §6 now §8 as amended by N.Y. Laws 1933, C. 470, §18.

[26] At least, one may so infer from the previously quoted statement by Acting President Miller. See *supra* note 12.

[27] N.Y.L.J., July 13, 1934, at 118.

The depressed condition of the real estate market in this city since the latter part of 1929 renders it difficult to arrive at the correct valuation for assessment purposes of the property under consideration for the year 1933 by the use of any single standard of computation.

It went on to state that, "It is perfectly proper to consider" original cost, "present structural value," and net income. But, it continued:

No single criterion may be depended on with absolute certainty, particularly in the unusual slump with which the real estate market has been visited during the past four or five years. Every one of the foregoing factors must be utilized, all of the above standards must be employed in measuring value. . . . In reaching my conclusion as to the correct assessment. . . . I have taken into consideration all of the foregoing elements.

By far the most significant of the New York opinions on depression-created assessment problems is *People ex rel. Rickey v. Hunt*,[28] in which the Appellate Division refused to reduce an assessment in Mechanicville for the year 1933. While holding that the taxpayer had failed to prove overvaluation, the court also declared that such proof, had it been adduced, would not have sufficed to vacate the assessment. For unless a taxpayer can prove inequality in his assessment as compared to those of other taxpayers, he has no grievance. Under Sec. 290 of the New York State Tax Law, said this court,[29] the respondent must establish three propositions: (*a*) that there is overvaluation, (*b*) that he is "aggrieved" by this overvaluation, and (*c*) the extent of the injury. An earlier dictum in *People ex rel. Powell v. Nassau County Supervisors*[30] is cited in support of this position.

[28] 241 App. Div. 261, 271 N.Y. Supp. 842 (3d Dept., 1934).

[29] *Ibid.*, at 264, 271 N.Y. Supp. at 847.

[30] 54 Misc. 323, 104 N.Y. Supp. 353 (Sup. Ct., 1907). In this case the relator's petition for a writ of certiorari, according to the court, did not show, as required by statute, that the application to correct the overvaluation had been made in due time to the proper officers. Application had been made to the board of supervisors to correct the assessment on grounds other than overvaluation. Overvaluation was first complained of in the writ of certiorari. For this reason, the court said, overvaluation as a ground for correcting the assessment could not be relied on. The court also said that from the proof before it, it was inclined to find that there was no overvaluation. Moreover, People ex rel. Warren v. Carter, 109 N.Y. 576, 17 N.E. 222 (1888), on which the dictum of the Powell case relied was incorrectly cited. In the Warren case, the taxpayer sought assessment reductions on several parcels of land. The Court of Appeals affirmed the reduction on one parcel where overvaluation alone had been proved. The lower court sustained a reduced assessment on another parcel on the ground that it had been disproportionately assessed. The Court of Appeals held this ruling erroneous because it was insufficient to prove, as the taxpayer had done, that similar property on the tax roll had been assessed lower than his. It was necessary to establish that the assessment would have

If the doctrine of the *Rickey* case should be established as the law of New York by the Court of Appeals, it would destroy the whole foundation for the innumerable taxpayers' suits that are now pending throughout the state. Indeed, when it was first announced, it is said to have created a sensation in the New York City Comptroller's office, which had hitherto encouraged compromises with irate taxpayers in order to minimize litigation. But the author is informed that the city officials are placing no reliance on this interpretation of the New York State Tax Law relative to certiorari proceedings and are continuing to assume that mere proof of overvaluation will be held to constitute a "grievance."[31]

Whatever may be the rulings on this point by the highest New York court, the tax assessors have succeeded in other jurisdictions in turning the "inequality-of-burden" argument against the taxpayers who, during earlier years, had used it successfully to secure reduced assessments on the ground of relative overvaluation. In *Sloman-Polk Co. v. City of Detroit*,[32] the Michigan Supreme Court upheld a lower court in dismissing upon the pleadings and offer of proof a Detroit taxpayer's bill in equity praying that a 1931 assessment be set aside because of its failure to take into account the decline in the value of the property alleged to have occurred since 1930. Declaring that the taxpayer's allegation as to overvaluation must be assumed to have been proved, since no evidence on this point was admitted, the higher court said:

> The overvaluation was not confined to plaintiff or its property nor to all classes of persons or property but ran against all property in the city, upon the same standard. A reduction of plaintiff's assessment to values of 1931, without corresponding reduction on all other property, would result, not in equality and justice to plaintiff, but in favoritism to it and injustice to

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resulted in the relator's paying more than his just share of the tax burden by virtue of the fact that the general assessment level of the tax roll was at a lower percentage than his. Nowhere in the opinion is there any suggestion that overvaluation alone is not a valid ground for reducing an assessment.

[31] Sec. 290 of the New York Tax Law (1909) reads as follows: "Any person assessed upon any assessment-roll, claiming to be aggrieved by any assessment for property therein, may present to the supreme court a petition duly verified setting forth that the assessment is illegal, specifying the alleged illegality, or if erroneous by reason of overvaluation, stating the extent of such overvaluation, or if unequal in that the assessment has been made at a higher proportionate valuation than the assessment of other property on the same roll by the same officers, specifying the instances in which such inequality exists, and the extent thereof, and stating that he is or will be injured thereby. . . . "

[32] 261 Mich. 689, 247 N.W. 95 (1933).

other property owners. A court of equity is never justified in rendering an inequitable decree.

No attempt has been made to secure all of the recent tax-appeal cases that face the critical issue, arising perhaps for the first time in American history, raised by the widespread drop in the market prices of real estate below the level of tax assessments. But the cases discussed above probably reflect the general attitude of the courts down to date. One notes an almost universal refusal of the courts to insist on those drastic reductions in assessment that would be called for by the test of current market prices. And one also notes that this refusal is based on either or both of two grounds: (*a*) that current market prices are too abnormal to reflect "real values" or "fair market values," and (*b*) that the taxpayer has no grievance unless his property is *relatively* over-assessed, so as to impose on him an undue share of the tax burden of the community.

What are the merits of these attempts to meet a desperate fiscal situation? Let us consider, first, the holdings which assume a wide discrepancy between evanescent, deflated *prices* and relatively stable *values*. Up to a point, this distinction is valid.[33] That is to say, appraisers, no less than courts, often make significant distinctions between current market price or market value on the one hand, and warranted price (sometimes called "intrinsic value") on the other hand. The contention that a parcel of real property, no less than a share of corporate stock, may be selling for more or less than its "fair value"—that is, for more or less than it would command if the prevailing market were more intelligent and less panicky and less subject to distress offerings—is plausible.

But there are two practical objections to the use of warranted price or "fair value," distinguished from current market value, as a basis of tax assessment. The first difficulty comes from the inability of even the most expert appraisers to estimate the fair selling prices of properties which are admittedly being sold at unfair prices. Valuations of this nature are mere forecasts of future market conditions; and business forecasting is not even a respectable art, to say nothing of its not being a science. The second difficulty is that expert valuations based on "fair selling prices" would almost certainly require reductions in assessments so drastic as to spell bankruptcy for many cities and states. This point would not be so serious, were it possible for communities to raise the *rates* of taxation so as to compensate for the reductions in the assessments. But constitutional and statute law, passed largely

[33] But as a matter of terminology, we prefer to describe this distinction, not as one between "value" and "price," but rather as one between *warranted* price (or value) and *market* price (or value). See *supra* p. 29, note 23.

through the influence of the real-estate interests, has built up impediments to this solution by imposing restrictions of debt limits to a certain percentage of assessed values, and by fixing limits upon the rates of taxation. In view of this situation, the frequent remark that the absolute amounts of assessments do not matter, and that only *relative* assessments are of any concern, is quite beside the point. During a depression, therefore, assessors and judges must conspire in a gigantic legal lie about property values—a lie which is concealed by all sorts of loose talk about the stability of real values as contrasted with the collapse of mere market prices.[34] In short, then, as long as the law gives to taxpayers the nominal right to insist on assessments which do not exceed the "fair market value" or the "actual value" of their real property, this law must be violated in fact through quibbling interpretations of the meaning of value or through the imposition on the taxpayers of burdens of proof that are deliberately made impossible to sustain.

We turn, then, to the alternative solution of the problem, to the frank admission by the courts that properties are being assessed at more than their full values, coupled with the ruling that the taxpayer may not complain except on the ground of *relative* overassessment. Such a solution is obviously subject to serious objections. It would in effect render void the constitutional and statutory debt limits and tax-rate limits based on assessed valuations. And unless supported by adequate machinery whereby the taxpayer could establish the ratio of overvaluation in his community, it would make hopeless any appeals to the courts except, perhaps, those brought by very large taxpayers who could spend hundreds of thousands of dollars in establishing the general level of assessment.

Yet in view of the fiscal situation that presents itself as this chapter is being written, this alternative solution may well be the lesser of two evils. So far as concerns the debt-limit and the tax-rate-limit laws, they are already largely nullified in effect by the refusal of the courts to require those drastic reductions in assessment that would have to be enforced in order to make them operative. A more frank and more complete nullification might well be in the public interest. So far as concerns the inability of taxpayers to prove *relative* overassessment, that difficulty might be minimized by state-wide determinations, under court auspices, of the

[34] Several months ago a New York state judge expressed the point clearly in a private conference with the writer. "I know perfectly well," he said in effect, "that we judges are refusing to enforce reductions in assessments to the levels that would be justified by all the established criteria of 'fair market value.' But what can we do? If we should enforce literally the traditional law of tax assessment, this city and that city (naming them) would at once find themselves insolvent."

prevailing factors of undervaluation or overvaluation in each community.[35] For the purposes of these determinations, assessments might be compared either with current market prices of real estate, however depressed these prices may be, or else with market prices as of some pre-depression year. Should the former choice be made, it might lead to an official finding, say, that for the current year, the average assessment in Manhattan is 50 per cent in excess of average market price. This would give to each taxpayer the right to relief if he could show that his assessment exceeds current market price by more than 50 per cent. Difficulties would arise with respect to valuable but unmarketable real estate—a point discussed in the following sections; and these situations would call for special treatment.[36]

Market Value versus Value to Owner.

Several cases have raised the question whether value for tax purposes means market value in the literal sense of realization price with respect to property that is obviously worth much more than this price to its present owner. Sometimes this issue has arisen when the pertinent statute requires the use of "market value" or "fair market value" as the basis of appraisal; for even here it is open to argument either that "market value" means sale price in a *hypothetical market*, or else that the statutory standard is applicable only when the property "has a fair market value." But when "true value" or some similar phrase is used in the law, there is room for the further contention that this value is not necessarily the same thing as market value.

The courts of Wisconsin have been the most outstanding of the strict constructionists in holding that market value, as used in the tax statutes, means realization price. In the city of Oshkosh there was a golf course, owned by a club which had invested $35,000 in developing it and whose members had no intention of selling the property.[37] Had

[35] Traditional equalization rates as fixed by equalization boards and other state commissions similar to the New York State Tax Commission would probably be inapplicable for this purpose. This is evidenced by the fact that the latter commission still regards New York City property as underassessed according to the 1935 rates fixed for the equalization of the special franchise and other taxes. These rates have remained substantially unchanged for the last fourteen years. See Annual Report of State Tax Commission (1931), N.Y. Legislative Documents (1932), No. 11, Table 17 at p. 99; and Annual Report of State Tax Commission (1932), N.Y. Legislative Documents (1933), No. 11, Table 10 at p. 86.

[36] A more revolutionary solution of the problem of real-estate assessment in a period of business depression would be the complete abandonment of "value of the property" as a tax base, and the adoption of some other basis of taxation, such as replacement cost. The possible merit of this suggestion has already been discussed, *supra* pp. 459–460.

[37] State v. Petrick, 172 Wis. 82, 178 N.W. 251 (1920).

they attempted to dispose of the links, they would have been compelled to sell them as meadowland, since no other purchasers for a golf course existed—so at least the court assumed, apparently not contemplating the possibility of sale to other golfers. Despite the probability that the property was worth at least $35,000 to the owners, the court held that it should be taxed only at meadowland value. Had the owners been deprived of the property by a condemnation, or by a fire insured against, there is no doubt but that the court would have awarded the "golf-course" price. Only then would there have been full compensation for the loss of the property. So, too, the owners, if incorporating, could have issued stock on that basis. But for the purposes of taxation, the court reached a very different result by insistence on the liquidation-price concept of market value. What sum of money, it asked, would be received if the land were offered for sale by the present owner to others? The Wisconsin statutes, to be sure, offered somewhat more basis for this interpretation than the usual general-property-tax provisions: "Real property shall be valued . . . at the full value which could ordinarily be obtained therefor at private sale." As the court read this, it pointed specifically to a liquidation price.

The same result was reached in a later Wisconsin case[38] involving the valuation of an office building peculiarly constructed to meet the requirements of its owner, an insurance company, and not readily convertible for use by others. The owner had no intention of selling the building, which had been constructed at a cost of $3,150,000 and would cost $4,000,000 to reproduce. On what basis the assessment attacked. $2,750,000, was cut to $1,700,000 by the lower court does not appear, Said the appellate court, in affirming this action:

> The argument that the owner may be considered as standing in the place of a purchaser who, if desiring to buy, would pay its reasonable intrinsic worth, forgets the statutory test, namely: What will it bring if the owner is the seller and somebody else is the buyer? The statute does not contemplate that the owner shall be both seller and buyer.[39]

[38] State v. Weiher, 177 Wis. 445, 188 N.W. 598 (1922). Here, as in the Petrick decision, the court stated that it was not objecting to reproduction cost as presumptively measuring the market value, in the absence of evidence to the contrary. State v. Norsman, 168 Wis. 442, 169 N.W. 429 (1918), which had done just this where the building did have potential purchasers, was approved in both the Petrick and Weiher decisions. *Cf.* National Lumber & Mfg. Co. v. Chehalis County, 86 Wash. 483, 150 Pac. 1164 (1915).

[39] See State v. Weiher, 177 Wis. 445 at 448, 188 N.W. 598 at 599 (1922). A Minnesota decision, State v. Russell-Miller Milling Co., 182 Minn. 543, 235 N.W. 22 (1931), purported to follow the Weiher case in the assessment of a mill. How-

The logic of the Wisconsin rule, it will be observed, leads to the strange result that the same property will be taxed less in the hands of one who is putting it to the more profitable of two possible uses. Thus, if the building in the insurance case had been built by an independent contractor for temporary use as an office building and eventual sale to an insurance company about to be organized, it would be taxable in his hands at a sum approaching insurance-building value; but as soon as the transfer took place, the valuation would have to be diminished, since the new owner could sell only for office-building purposes.

In marked contrast with the position of the Wisconsin Supreme Court is that of the New York courts in a recent litigation over the tax assessment of the New York Stock Exchange building.[40] The assessors there had valued the building in 1921, over and above the value of the land, at approximately two-thirds of original cost in 1903, which was about one-half of estimated replacement cost. Counsel for the Stock Exchange argued that the assessment should not exceed the value of the bare land, since the building was quite unique and would be of no possible use for any other purpose, not even for any other stock or produce exchange. In support of this plea, plaintiff offered to prove by the testimony of real-estate experts that, for liquidation purposes, the building was actually a nuisance and would reduce rather than enhance the value of the land. None of these contentions of fact seem to have been disputed by counsel for the city. Yet the Appellate Division and the Court of Appeals (without a reported opinion) upheld the tax assessors in placing a value on the property far in excess of the value of the land alone. In so doing, however, the Appellate Division met the objection that market value, strictly speaking, means sale value, by observing that the tax statutes call for the "full value," and by holding that market value was to be used as a criterion only under circumstances where it faithfully reflected the full, true value. The opinion does not explain what is meant by true or full value. Apparently, however, the terms were used in order to justify an assessment based on the value of the property to its existing owner, rather than on liquidation price.

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ever, there was no indication that the mill property possessed any peculiar value to the owner. Presaging an abandonment of the Wisconsin doctrine where the property is of such magnitude as to preclude a ready market, the court, in State ex rel. Flambeau v. Windus, 208 Wis. 583 at 585, 243 N.W. 216 at 217 (1932), said that factors like book value, the price at which the property was listed for sale, and the insurance carried, might be considered in computing "sale value."

[40] People ex rel. N. Y. Stock Exchange Bldg. Co. v. Cantor, 221 App. Div. 193, 233 N.Y. Supp. 64 (1st Dept., 1927), *aff'd*, 248 N.Y. 533, 162 N.E. 514 (1928).

A similar distinction, made for a similar purpose, may be found in a Connecticut decision involving the valuation of the Underwood Typewriter works in Hartford.[41] Here it appeared that the original cost of the plant was $1,481,000 and that the assessors had appraised the property at $2,432,700, doubtless taking account of the higher construction costs prevailing at the time of the assessment. The lower court had reduced the assessment to $1,700,000, saying that the basis of the tax under the statute was "market value" and that the reduced figure fairly represented that value. But the Supreme Court reversed the lower court and remanded the case for retrial, on the ground that market value was not here the proper test. This holding was made in the face of statutes providing that buildings used for manufacturing purposes should be assessed "at their present true and actual valuation" and that "the present true and just value of any real estate shall be deemed . . . to be the fair market value thereof, and not its value at a forced or auction sale."

Commenting on these provisions Judge Burpee said:

> Ordinarily market value means a price fixed by sales in the way of ordinary business, and is established when other property of the same kind has been bought and sold in so many instances that a value may reasonably be inferred. The term contains the conception of a market, or conditions, in which there may be found a willing seller and a willing and able purchaser.[42]

In the present case, however, continued Judge Burpee, it would have been difficult to get a purchaser at any price, and quite impossible to get one at any price that the owner could fairly be expected to accept. "In fact, at that time there was no market for the property, and it did not have a value which was the fair market value in the proper and approved meaning of the term."[43] He concluded that, since there was no market value properly speaking, and since the legislators certainly could not have intended to exempt such property, its "true and actual value" should form the tax base. But Judge Burpee, like the New York court in the previously mentioned case, failed to add what "true and actual value" means. He did indicate that both actual cost, with corrections for depreciation and for changing price levels, and estimated replacement cost depreciated "have often been

[41] Underwood Typewriter Co. v. City of Hartford, 99 Conn. 329, 122 Atl. 91 (1923).

[42] *Ibid.*, at 334, 122 Atl. at 93. The statutory provisions in question were Conn. Gen. Stat. (1930) §§1183, 1197. From the reasoning of Judge Burpee, Judge Beach sharply dissented.

[43] *Ibid.*, at 334, 122 Atl. at 93.

resorted to and considered," although neither is necessarily to be taken as an invariable measure of value.[44]

One might infer from these cases that only those courts which set up "real" or "true" value as a test are free to approve an assessment which takes account of the higher value of the property to its existing owner. This is not so, however; for in other states, courts have attempted to remain faithful to the market-value phrase while distinguishing it from the price at which the property could actually have been sold. In New Jersey, for example, the statutory criterion of the tax base has been substantially the same as that of Wisconsin: the price that the property "would sell for at a fair and bona fide sale by a private contract."[45] Yet in applying this statute, the courts have conjured up a *hypothetical* sale at which there will be bidders who want property of the very type the taxpayer possesses, even though it is clear that if the property were actually offered for sale no such bidders could be found. A decision of the Court of Errors and Appeals frankly declares this.[46] The taxpayer asked and was granted a substantial abatement on the ground that he had introduced into his residence a number of "features and fancies" that added nothing to its salable value though greatly increasing its cost. But the court took care to add:

> We are not disposed, however, to give much force to the argument that because there are very few actual buyers for so costly a residence the valuation to be placed upon it under the statutory criterion should be correspondingly depreciated. The criterion established by the statute is a hypothetical sale, hence the buyers therein referred to are hypothetical buyers, not actual and existing purchasers.[47]

One notes in this case a rejection both of an out-and-out market-value criterion and of an out-and-out value-to-the-owner test. On the one hand the court refused to reduce the tax to the low price for which "so costly a residence" might have been sold in view of the dearth of actual wealthy buyers, and on the other hand it did make some abatement in view of the fact that the existing owner had embodied in his residence queer ideas which would not be appreciated by anyone else.

[44] Smyth v. Ames, 169 U.S. 466 (1898), and other public-utility rate cases were relied upon.

[45] N. J. Laws 1903, p. 398, §6.

[46] Turnley v. Elizabeth, 76 N.J.L. 42, 68 Atl. 1094 (1908).

[47] *Ibid.*, at 44, 68 Atl. at 1095. The doctrine of the hypothetical buyer was approved in United New Jersey, etc., Co. v. State Board, 100 N.J.L. 131, 125 Atl. 355 (1924). See also General Electric Co. v. City of Erie, 110 Pa. Super. 206 at 212, 168 Atl. 531 at 536 (1933).

In other words, the court was willing to indulge in the hypothesis that there would be other wealthy persons who wanted large, handsome residences in that community, but was unwilling to extend the hypothesis to assume that these wealthy individuals had the same odd tastes as the present owner.

An ambiguous and troublesome decision was handed down in Massachusetts some years ago in connection with the assessment of a private lunatic asylum.[48] The trial court refused to give the following charges at the taxpayer's request: "The value of the real estate in question to the petitioner over and above its value to any other owner is not to be included in fixing the 'fair cash value,'" and "The 'fair cash value' of the estate for the purposes of taxation cannot exceed the sum which the owner after reasonable effort could, at the date as of which the assessment is made, obtain for it in cash." In a memorandum opinion the trial judge justified his refusal on the following grounds:

> The accepted phrase "market value" is properly applicable to all cases where there is a market, but that does not mean that monopolies must go untaxed. The taxable value of a railway station is not affected by the fact that so long as the present owner holds the franchise and the tracks, no purchaser would have any use for the buildings. If a part of the Harvard College yard were to be taken by right of eminent domain, the college could demand compensation for buildings destroyed, although those buildings have but one use and there is and can be but one Harvard College. The frank method of dealing with such a case would be to say that where the prudent owner would immediately replace the building if it were destroyed replacement value furnished the true test. But the conventional method is to retain the old phrase, and to expand its meaning to meet the new demand, and our courts have heretofore shown themselves to be equal to this task.

The appellate court held the refusal to give the requested charges to be reversible error, stating:

> The fair inference from this statement by the judge and his refusals to rule is that the judge did not confine himself to the rules of law already stated, which in cases of this sort restrict the value to an ascertainment based on cash or market value. . . . The denial of these requests combined with the statement made by the judge indicates that an appreciable increment of value might have been added due to the special and peculiar value which the property had to the petitioner above that which it had in the market.[49]

[48] Massachusetts General Hospital v. Belmont, 233 Mass. 190, 124 N.E. 21 (1919). See a later opinion in the same case, 238 Mass. 396, 131 N.E. 72 (1921).

[49] *Ibid.*, at 209, 124 N.E. at 28.

Nevertheless, the appellate court approved the trial judge's charge that "The fair cash value of the real estate in question is the value which it would have had on April 1st, in the hands of any owner, *including the present owners.*" And to make the confusion complete, it criticized the judge because "he did not confine himself to a consideration *of what a prudent person in the position of the . . . [taxpayer] would have given for the property* rather than not have bought it, but went beyond a point where there would have been competition among probable buyers into the region of value to the petitioner alone."[50]

Clearly the value of the property to the present owner, and what he might have bid for it, would exceed what he could obtain for it in cash, and would therefore involve the forbidden excursion "into the region of value to the petitioner alone." Perhaps the opinion can be harmonized on the assumption that the Massachusetts court had in mind a hypothetical sale, but a sale differing from that contemplated by the New Jersey courts. In the Massachusetts hypothetical sale, the taxpayer is not selling to a hypothetical buyer, but is himself among those bidding for the property. In such a case, the taxpayer might not have to bid up to the full extent of the property's special value to him, since he would be the sole bidder as soon as he bid a shade above the highest value to other people. But such reasoning is highly artificial, and it fails even to take account of the existence of bidders whose only use for the property is to resell it to the person who really needs it, namely, the present owner, and who might bid up to a point slightly *below* the special value to the present owner.

In the same opinion the court pointed out that there might be a difference between the award in eminent-domain cases and the assessment in a tax case:

> Frequently, in support of principles of general application, decisions in tax cases and in eminent domain are cited indifferently. Commonly fair cash value or fair market value affords adequate compensation to an owner whose property has been taken from him by eminent domain, and is the right basis for the assessment of taxes. . . . But the rules in the two classes are not always and necessarily the same. There may be instances where the market or fair cash value is small or almost negligible and does not represent indemnity or the "reasonable compensation" required by art. 10 of our Declaration of Rights.[51]

Having suggested this distinction between value for taxation and value for condemnation, the court proceeds to cast doubt upon it by the following statement:

[50] *Ibid.* (Italics ours.)
[51] *Ibid.*, at 207, 124 N.E. at 27.

It is possible that taxation cases may arise where, in order to give rational effect to the declared intention of the Legislature, the words "fair cash value" must be given a somewhat more elastic significance than heretofore has been attributed to them. See, for example, taxation of railroad depots and stations, St. 1906, c. 463, Part II, §79; of land and property owned by street railway companies, *Connecticut Valley Street Railway v. Northampton*, 213 Mass. 54; of underground conduits, poles and wires of electric light and power companies, St. 1909, c. 439, §1, where there is no right of sale in its ordinary sense. . . . *But it is not necessary to discuss or decide that point*, and no opinion respecting it is expressed.[52]

Vagueness of the Legal Value Concepts.

The foregoing discussion of the concept of value as applied by the courts in property-tax cases is far from giving the clear definition that might be hoped for. Certainly we are left with a very incomplete picture of the valuation process as applied day by day in a multitude of jurisdictions to countless parcels of property.

Why this vagueness in the concept of value? For one thing, even the most conscientious tax collector will tend to dodge debatable points, to give the taxpayer the benefit of the doubt. To hew close to the line of theory may give satisfaction to economists, but it will assuredly cause a stampede of irate citizens on grievance day. "Interesting questions" usually die stillborn.

Then, too, of the assessments protested by taxpayers, relatively few reach the courts, fewer still the appellate courts whence reported opinions come. Most complaints are heard by administrative tribunals: the board of assessors or local governing bodies or a tax board. Appeal to the courts from these administrative decisions is impossible in many states. In the others, it is expensive and tedious and may be hedged about with important restrictions, such as that all questions of "fact," and even of the application of concepts to the particular disputed facts, are foreclosed. A detailed discussion of the extent of judicial review of assessments will not be attempted. Suffice it to say that the direct review of administrative tax valuations by the courts is a modern innovation, only gradually making its way into general property taxation. The older method was to profess administrative freedom from judicial review, but at the same time to leave the assessments open to collateral attack in court where unconstitutionality, fraud, or excess of jurisdiction could be shown. Opinions in tax cases devoted more space to technical discussions as to what questions are thus directly reviewable than to the merits of the questions. Even today many of these clogs upon judicial review exist.

[52] *Ibid.*, at 208, 124 N.E. at 27–28. (Italics ours.)

The difficulty of effective review, even where it is otherwise possible, is intensified by the widespread practice of assessors and commissions of concealing the processes by which they reach their valuations. For where review *is* possible, it extends (in all but a few states) only to cases where the officials have used a wrong method or proceeded upon a wrong principle; mere excessiveness in valuation is not, without more, subject to correction. Indeed, the taxpayer must make a clear showing of error in method to overcome the burden of proof upon him and the presumption of official rectitude. Knowing this, tax administrators frequently shroud their valuation processes behind some such report as "Neither have we adopted any one particular theory of value, but we have endeavored to give due consideration and weight to all theories and elements of value." Naturally, sharply defined questions of theory cannot be thus presented and reviewed.

Having summarized the judicial theories, such as they are, as to what constitutes tax value, and having noted how vastly more important is the actual practice of valuation, we turn now to the practice.

III. The Practice of Real-estate Assessment.

Tax assessments differ from most other legal appraisals in being levied by an officer who is both nonjudicial (hence not subject to formal rules of evidence) and free, within wide limits, from judicial scrutiny and from a resulting tendency toward standardization enforced by appellate courts. The briefest summary of assessment practice will suffice to show the latitude given to the assessor by the courts.

In general there are two different methods of assessment in America —the standardized method and the individual-judgment method. The former is the prevailing one in the larger cities; the latter is the usual one in all other communities and in rural areas. Each will be considered in turn.

The Standardized Method: Valuation of Land.

Much has been written about the standardized system of urban realty valuation, the general outlines of which differ little from city to city.[53] Since the system calls for separate appraisal of the land and

[53] See the following references: Bernard, *Some Principles and Problems in Real Estate Valuation* (Baltimore, 1913); Brown, *Common Methods of Valuing Property for Taxation* (1914); Cowles and Leenhouts, *How to Assess Property in Cities and Rural Towns* (Madison, 1914); Heydecker, *Tax Maps* (1913); King, *Valuation of Urban Realty for Purposes of Taxation* (1914); Powell, *Taxation in New York* (1924); Somers, *Valuation of Real Estate for Purposes of Taxation* (1901). See also Pollock, "An Equitable Standard of Land Valuation," 7 *Nat. Tax Assn. Proc.* 234 (1913); Floydell, *The Use of Standards in Real Estate Taxation* (1909).

the improvements thereon, this brief résumé will be divided along the same lines. It is to be remembered, however, that assessors are not generally bound to adhere rigidly to the valuations to which their standard methods would lead. In New York City, for example, the assessors are called upon to exercise their individual judgment, based on all kinds of data which they are encouraged to enter into their "field books." Standardized methods are used by them merely as guides. In other cities, however, greater reliance is placed on the formulas and less reliance on discretion.

In the valuation of the land, the first step is to obtain the value per front foot—sometimes per square foot—of a normal lot inside the block on street level in the neighborhood.[54] Maps are prepared for the city showing these unit values, usually one for each block—the values gradually rising and falling in rough proportion to distance from high-value centers. In computing unit values, the tax assessor seeks information concerning: (*a*) Previous tax assessments; (*b*) previous sales, both private and public; (*c*) mortgage loans as stated in recorded mortgages: (*d*) lease and rental figures; (*e*) miscellaneous facts sometimes supplied by the experts of real-estate organizations.[55]

Rarely will all these data be available as to every lot in the block. More often the assessor will learn of a recent sale of one lot, the mortgage on another, and a long-term rental of a third. Out of this medley he extracts a general notion of land value in the area, which he adjusts with reference to previous assessments and to the valuation figures for neighborhood areas. The mental operations by which he performs this act of judgment need not be reported or testified to by him; but boards of review and courts usually have power to correct clear mistakes.[56]

[54] A normal lot is in Manhattan 24 by 100 feet, in Queens 20 by 100, in Cleveland 25 by 150. As to plottage, see People ex rel. Loeser v. Goldfogle, 249 N.Y. 284, 164 N.E. 100 (1928).

[55] 6 *Nat. Tax Assn. Proc.* 347 (1912). Insurance figures are considered inapplicable. Compare the rule in Switzerland, where many cantons compel assessment at insurance value. Bullock, "The General Property Tax in Switzerland," 4 *Nat. Tax Assn. Proc.* 53 (1910).

[56] The assessor need not be an expert: Washington Union Coal Co. v. Thurston County, 105 Wash. 208, 177 Pac. 774 (1919); Keokuk & H. Bridge Co. v. People, 161 Ill. 514, 44 N.E. 206 (1896) (even in the valuation of a great interstate bridge). But in Sioux City Bridge Co. v. Board of Review, 192 Iowa 1224, 184 N.W. 733 (1922), the court in distinguishing Iowa Central R. R. v. Board of Review, 176 Iowa 131, 157 N.W. 731 (1916), showed how much more critical is review of a valuation by one not familiar with the kind of property involved. And *cf.* People v. Clapp, 152 N.Y. 490, 46 N.E. 842 (1897), in which the Court of Appeals dwelt at length upon the inability of local officials to cope with intricate problems of valuation.

The consideration expressly recited in deeds is obviously poor evidence, since often the figure recited is either nominal or depressed with tax collection in view, or else is exaggerated to aid resale;[57] and efforts to have a statement of true consideration compelled in every recorded deed have been unsuccessful.

Paucity of other evidence naturally increases reliance upon previous assessment figures, however they may have been established. But the strong influence of previous valuations is not confined to cases where other evidence is hard to obtain. Final unit figures are always largely determined by former assessments. The inertia inherent in governmental operations, the desire to take the easiest and least offensive course, must be reckoned with. Property values and, even more, the values of leases are rudely jarred by a change in tax valuation. The relation of assessments in one area to those in another, and to the centralized state assessment of special properties, is likely to be disturbed, with consequent protest on every hand. And, if litigation arises, the assessor who changed a previous year's valuation is likely to be forced, whether formally or not, to sustain the burden of showing a change in local conditions. A former assessment acquiesced in by the taxpayer and his neighbors is a fixed point from which drift and change may be measured.[58]

When unit values of the normal lot have been arrived at, adjustments must be made for individual parcels, with respect to depth, width, corner and alley influence, grade variations, rock and other impediments. For this purpose, there are in use several sets of tables —constructed on the basis of a generalization of a multitude of past cases by simple averaging or some other mathematical operation— which give a percentage to be added to or subtracted from the normal lot value as allowance for each factor. For example, one such table enables the assessor to make concrete application of the principle that frontage is more important than area, by telling him that a lot with normal frontage but only half the usual depth is worth 72.5 per cent of normal; while a lot with that frontage but twice the normal depth is worth 122 per cent of normal; and a triangular lot with the full frontage as base line and normal depth is to be valued by "squaring the tri-

[57] See the criticism of reliance upon such evidence in Coulter v. Louisville & N.R.R., 196 U.S. 599 at 609–610 (1905).

[58] To so great a degree does this tendency obtain, that courts sometimes have to be called in to reduce assessments which have too long remained unchanged despite a great depreciation of property values in the neighborhood. Aspegren v. Tax Assessors, 125 Atl. 213 (R.I., 1924). And mere general acquiescence will not save assessments demonstrably bad. People v. Stewart, 315 Ill. 25, 145 N.E. 600 (1924).

angle" and applying the depth table as if the lot's depth were half normal.[59]

The tables in use vary considerably. Thus the percentage for a lot of half normal depth is given in six leading tables as 72.5, 57.5, 67, 70, 70.5 and 65.3; while for double depth we find 122, 170, 125, 122, 141.4, and 149.[60] Such comparisons prove the obvious: that these tables, being purely empirical generalizations of so many thousand past instances, have no claim to great precision. They are certainly not reliable as to one particular piece of property. Suppose, for instance, that on assessment day the "perfect sale" of a 50-foot-deep lot takes place, for $10,000. All other things being equal, a 100-foot-deep lot on that street is worth, according to one table, $17,000, no more and no less. But who can say with assurance that that is the price the lot would have brought?

That the mechanism has been administratively successful as compared to purely individual assessments there can be no doubt. Its primary benefit has been the reduction of assessments to a basis of comparability. Though the unit system has not eliminated guesswork from valuation, it has reduced the number of guesses. Furthermore, to the extent that the table is the accurate mathematical deduction from a very large number of instances, it is superior to the assessor's guess, which is an intuitive conclusion from a more limited experience. Arbitrary action by the deputy assessor is minimized; errors of judgment and miscalculations can more easily be detected. In New York City, where over 800,000 parcels are now annually assessed[61] the element of ordinary error is no small item. Only too frequently the taxpayer feels that he has been made the object of dishonest practice and deliberate persecution on the part of the assessor.[62] Such suspi-

[59] See Bernard, *supra* note 53, at 32; Cowles and Leenhouts, *supra* note 53, at 21.

[60] Figures are from King, *supra* note 53.

[61] In 1924, when the number of parcels of land assessed in New York City was 657,542, the average cost per parcel was $1.03. *Report of Commissioners of Taxes and Assessments of New York City for* 1924. It has been estimated that the average time devoted by the New York Tax Department to each assessment is about a minute and a half.

[62] In New Zealand the taxpayer has been allowed to fix his own valuation subject to the state's right to purchase at that price. Scheftel, *Taxation of Land Values* (1916), p. 77. Although no similar provision has been found in this country, an occurrence in Cleveland seems interesting. The advent of a new tax commission resulted in "increased assessments from three to ten times what they had been before." To the swell of protest which immediately ensued "The commission's reply was that any one who was dissatisfied with his valuation could post an offer to sell at the appraised value; if the commission was not able to dispose of

cion is minimized when the taxpayer can be shown exactly how the figure was arrived at, especially when that was the way that all his neighbors were treated.

The new method of valuation has rarely been challenged in the courts,[63] and when challenged has usually been respected. Even the Wisconsin court, with all its devotion to the literal meaning of market value, could see nothing improper in the conduct of an assessor who, after appraising the most valuable block, proceeded to assign a site value to other blocks by successive reductions of $5 per front foot.[64] And this, despite the unusual Wisconsin statute requiring assessors to make their valuations from "individual view," a statute which in 1875 had been held violated by an assessor who, in valuing a large area of forest land, adopted a scale of "Pine on first-class streams, two mile hauling, $2.00 per M; on second-class streams, two mile hauling, $1.50," etc.[65] To a certain extent, this pair of cases reveals a change in point of view; but the two are reconcilable, in theory at least, since the modern method provides for inspection and adjustment of individual parcels after the unit figure for the area has been arrived at. The Pennsylvania court has made and repeated a dictum to the effect that "Scientific formulas, arithmetical deductions, and mental contemplations, have small value in making assessments under our practical system of taxation"; but the case occasioning this dictum was again distinguishable on its facts.[66]

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the property at the valuation placed on it, it would reduce the assessment. This effectually closed all protests; no one took advantage of the offer." Howe, *Confessions of a Reformer* (1925) p. 228.

[63] The paucity of judicial comments on the standardized methods of real-estate assessment may be due largely to the inability of taxpayers to impugn an assessment by attacking the method by which it was reached. As a rule the courts have confined the contest solely to the question whether the assessment, however reached, in fact represents an overvaluation. In New York, at least, the taxpayer cannot compel the assessor to take the witness stand in defense of his appraisal, and the usual practice of the New York City Tax Department is to rely entirely on outside expert witnesses. These witnesses may not even be informed of the method by which the assessment was reached.

[64] State v. Norsman, 168 Wis. 442, 169 N.W. 429 (1918). And note the sanctioning of the cubic-foot method of valuation in the Weiher case itself.

[65] Hersey v. Board of Supervisors, 37 Wis. 75 (1875).

[66] See Delaware, L. & W.R.R. Co. v. Luzerne County Com'rs, 245 Pa. 515 at 516, 91 Atl. 889 at 890 (1914), quoted with approval in Re Kemble's Estate, 280 Pa. 441, 124 Atl. 694 (1924). *Cf.* In re Lehigh & Wilkes-Barre Coal Co.'s Assessment, 298 Pa. 294, 148 Atl. 301 (1929). In this case, under a statute requiring the assessment to be "not less than the same would bring . . . at a public sale" (construed as market value), the court upset a valuation of coal deposits arrived at by application of the foot-acre rule.

The Standardized Method: Valuation of Improvements.

In the assessment of vacant land by the use of standardized formulas, the final result is reached by the procedure just outlined. But most urban tracts are not vacant, and it is therefore necessary to allow for any additional value which the improvements may have conferred on the property as an integral whole. Under the standardized methods of assessment, this allowance is made by what is called a separate valuation of the buildings or other structures, and the sum of the two values is taken as the value of the improved property.

Although a separate valuation of land and of improvements is called for by many of the statutes as well as by the practice of assessors, the fictitious nature of this separation is apparent. One simply cannot find the value, say, of the Stevens Hotel property in Chicago or of Mr. Schwab's residence in New York by adding the value of the ground devoid of the building, to the value of the building devoid of the ground.[67] The attempt to do so would result in the same error that would be committed were we to seek the value of Raphael's *Sistine Madonna* by adding the separate value of the lower half of the canvas to the separate value of the upper half.

In reality, however, what the separate appraisal of the two portions of the property attempts to portray is, first, what the land would be worth on the fictitious assumption that it is vacant, and second, how much more than this figure the entire property is worth because improvements have been erected on the land. When an assessor submits a report on "the value of the building" he is therefore at best presenting an estimate of the extra value of the whole property over its hypothetical vacant-land value.[68] This procedure may be defensible in the extremely crude appraisals that are necessary under a real-estate tax, because it permits the use of mechanical formulas that would be unavailable if a more direct estimate of the property in its entirety were attempted.

But the use of these mechanical formulas for the purpose of deriving the added value contributed by the building involves an inference, which is never strictly valid and often wildly wrong, that this value is measured by the cost of reproducing the structures minus standardized deductions for physical and functional depreciation. Assessors them-

[67] See State v. Thompson, 151 Wis. 184 at 187, 138 N.W. 628 at 629 (1912).

[68] A Massachusetts court explained to the assessors that the value of a building should be determined by subtracting the value of the vacant land from the value of the whole property. Tremont & Suffolk Mills v. Lowell, 163 Mass. 283, 39 N.E. 1028 (1895). But this method of appraisal is unavailable unless the value of the entire property is already determined, which is not usually the case.

selves often recognize the dangers of any such inference and attempt to correct them by revisions based on "judgment," at least in extreme cases. Courts, on occasion, have insisted on modifications or even on complete rejections of the figures reached by the standardized methods. But seldom have they done this except in cases where the results reached by the assessor seem *grossly* unfair to the taxpayer. On this point more will be said later. Meanwhile we may explain briefly the formulas for measuring depreciated replacement costs.

It is assumed that urban buildings may be analyzed into a small number of types, for each of which there is a normal construction cost. Descriptions and photographs of these type structures, appropriately classified, appear in the assessor's handbooks. With them are given tables of costs, averaged over the square or cubic foot, for the respective types, and also straight-line or curved graphs showing the percentage to be deducted from the reproduction cost of the particular building assessed in determining its depreciation. All the assessor need do is to classify the building, ascertain its age, and estimate its area or volume. The rest is a simple mathematical calculation—area or volume multiplied by the unit cost for the type, minus an amount for depreciation that increases each year according to the stated percentage in the tables. Theoretically the tables are supposed to be brought down to date to reflect changing reproduction costs; actually, although construction costs change from year to year, the tables used by the assessors are revised much less frequently.[69]

Nonstandardized Assessment of Real Property.

Nonstandardized assessments are usually found in the smaller cities and in rural areas, although they are also used in large cities with respect to unique types of property. There are three difficulties in the way of standardizing assessments of land outside of the great urban centers. First, the unit value of "normal" land is hard to establish because there is not the same active market as in cities,[70] and also because there is not the same well-organized administrative force.

[69] *Report of the Department of Assessor of St. Paul* (1922), p. 16. Zangerle, *Principles of Real Estate Appraising* (1924), pp. 228–230, calls attention to the fact that appreciation is rarely added to a building assessment. Hurd, *Principles of City Land Values* (1924), p. 127, says: "quite uniformly property which has been valuable but is deteriorating is assessed higher than property in the line of growth."

[70] See an interesting recent study on "Turnover of Title to Real Property in New York," by Edwin H. Spengler, printed as Memorandum No. 4, *Report of the New York State Commission for the Revision of the Tax Laws* (1932). In New York City, about 75 per cent of the real estate, by area, was turned over between 1920 and 1930, and about 50 per cent between 1925 and 1930. Lower turnovers were found for smaller communities, dropping to from 30 to 40 per cent during the decade for rural and semirural areas.

Secondly, the factors differentiating each parcel of such land from the "normal" parcel in the locality have only recently been mathematically analyzed in the same way as corner influence or lot shape under the urban system. Finally, there is not the same uniformity in size or shape of the land, or in the nature of the improvements.[71]

Concerning realty assessment not based upon standardization, little has been written and little can be said. It is in essence based upon judgment—the judgment of the assessor, subject to such limited court review as may be provided. The procedure of the assessor, after ascertaining the assessment figures for previous years, is to inspect the property and to obtain what information he can about sales, leases, and yield of this and of similar parcels. Neighborhood sentiment about the property, guesses more or less well informed about its future, and, above all, the assessor's intuitive reactions, are factors in the emergent value figure.

A recent decision of the New York Court of Appeals,[72] reviewing the valuation of a large tract of land under water, is indicative of the processes involved in such unstandardized appraisals—all the more indicative because the New York statutory system of review gives courts much wider powers of valuation than is usual in other states. The Lehigh Valley Railroad acquired over a period of years, from the state of New York and from private owners, a large tract of land consisting of a 12-acre strip along the east short of Lake Erie and the land adjacent thereto but under water (215 acres). The purpose of the acquisition does not appear. The railroad tracks ran up to the eastern boundary of this land. The challenged assessment was for the year 1923 and amounted to $1,378,000 for the entire parcel. Up to the time of the hearing in 1926 the railroad had made no use of the land. The land not acquired from the state was purchased in 1921 at $750 per acre. The assessment complained of was $6,000 per acre. The other data presented to the court included: sales of much smaller tracts at highly infrequent intervals, some during wartime, at from $17,000 to $25,000 per acre; sale of a small tract of filled land at $17,000 per acre; undisputed proof that the cost of filling was $30,000 per acre; and an expert appraisal of $10,000 per acre submitted by the taxpayer to the Interstate Commerce Commission in an application to obtain authority for a security issue.[73] The assessors, stressing the taxpayer's own valuation for other purposes, found a value of $6,000 per acre

[71] The Department of Agriculture has been working out a factor table for farm lands with respect to the influence of crop productivity, means of transportation, etc.

[72] People ex rel. Lehigh Valley Ry. v. Burke, 247 N.Y. 227, 160 N.E. 19 (1928).

[73] The value of the land was not a factor to be considered in the application, and the appraisal was based upon a contemplated sale that was never executed.

The Court of Appeals (one judge dissenting) sustained a referee's reduction to about $2,000 per acre, reasoning that the uncertainty as to the owner's ability to make a profitable use of the land within a reasonable time was the controlling element.[74] Judge Kellogg first inquired whether "any parcel of land, similar in area, location, and adaptability," had ever been the subject of purchase and sale or offer; then, whether it had ever "produced a revenue." The answers to both questions being negative, the valuation, he said, "must necessarily rest in the opinion of the trier of fact, based upon data of an exceedingly uncertain and unsatisfactory character." "What are the possibilities, according to such data as we have," he asked, " of the owner's deriving future return from the land in excess of the cost and carrying charges?"[75]

Where sales of realty are frequent, so that the finding of market value can proceed by a more or less direct reference to actually established market price, no special attention need be given these possibilities of more profitable use: they are automatically reflected in current prices. But where sales are few, the assessor is thrown back upon his own speculations as to whether land actually put to an unprofitable use could, with reasonable outlay and risk, be converted to a more profitable use, or whether land is so likely to become more highly desirable in the future by reason of a change in conditions that its present market value should be determined more by discounting expected future profits than by capitalizing present profits.[76]

[74] The taxpayer had not appealed from the referee's finding.

[75] The only authorities cited in the majority opinion are Boom Co. v. Patterson, 98 U.S. 403 (1878), and First Construction Co. v. State of New York, 221 N.Y. 295, 116 N.E. 1020 (1917), both eminent-domain cases. The dissenting opinion of Judge Crane stressed the valuation offered to the Interstate Commerce Commission. His opinion states (247 N.Y. at 238, 160 N.E. at 23): "I think a good safe way to proceed in all these matters is to take the railroad company at its own valuation. It at least leads to fair dealing. Such methods justify criticism and lack of public confidence. If $10,000 was a proper valuation upon which to get money, $6,000 was none too high for taxation. I know of no rule which permits such drastic fluctuations according to the purpose of a valuation."

[76] Under the English property tax such questions rarely arise. The tax is based upon the fair net annual rental value, *i.e.*, the rent for which the land might reasonably be expected to let from year to year, minus the expenses of upkeep. Rates are normally paid by the occupier, not the owner, and it is felt unfair to make one who probably does not own the land pay on the basis of a possible alternative use that is of no present or potential concern to him. See Skrimshire, *Valuations* (1915), p. 288; Tucker, "British Taxes on Land Values in Practice," 29 *Quart. Jour. Econ.* 194 (1915). To be sure, the rental actually reserved is only prima facie indication of the fair rental value. See, *e.g.*, King v. Shoreditch Assessment Committee, [7910] 2 K. B. 859; and cases cited in N. Matthews, "The Valuation of Property

How far such speculation may be carried is a much-litigated question. There is a natural reluctance to go beyond the value based upon the present use in the absence of clear proof that there is or will be another use. Thus, the New York Court of Appeals set aside as "too speculative" an assessment of a large plot one block from the business center of a town, which was valued on the basis of what it would sell for if divided into building lots rather than retained as a lawn and barn site.[77] And in another case, [78] the assessor who proceeded on the basis of his mental picture of beautiful villas rising where there now is only rock, was told that he had failed to prove that there would be a market at prices justifying the cost of improvement. But that these decisions merely insist upon adequate proof is shown by a court's acceptance of an assessment of farms on Long Island at more than farm value because of an influx of city millionaires anxious to purchase estates.[79] A Connecticut case upheld an assessment of farm acres as potentially subdivided building lots. The taxpayer carried his protest to the United States Supreme Court on the ground that he was being deprived of property by illegal action of the assessors, but the Supreme Court refused to review the case.[80] And statutes explicitly ruling out of assessors' consideration the possibility that agricultural lands within city limits might not be used for that purpose forever, have been held inconsistent with constitutions requiring that taxation be according to value.[81]

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in the Early Common Law," 35 *Harv. L. Rev.* 15 at 28 (1921). But the instances in which the actual rent is departed from by assessors seem to be those where the amount reserved does not properly reflect the value of the present use, not where the land might possibly be rented for a more profitable use. By special legislation, however, owners of unoccupied land in London are taxable with respect to its value.

[77] People ex rel. Strong v. Hart, 216 N.Y. 513, 111 N.E. 56 (1916).

[78] People ex rel. Empire Mortgage Co. v. Cantor, 197 App. Div. 437, 189 N.Y. Supp. 646 (1st Dept., 1921), *aff'd*, 234 N.Y. 507, 138 N.E. 425 (1922).

[79] People ex rel. Town of Hempstead v. State Board of Tax Commissioners, 163 App. Div. 803, 149 N.Y. Supp. 239 (3d Dept., 1914). *Cf.* People ex rel. Lehigh Valley Ry. v. Burke, 247 N.Y. 227, 160 N.E. 19 (1928), cited *supra* note 72, where even the Court of Appeals showed that it attached weight to the possibilities of future use. See a very good annotation on "Prospective Value as Basis of Valuation of Land for Purposes of Property Taxation," Note, 24 A.L.R. 649 (1923).

[80] Wilcox v. Munger, 276 U.S. 606 (1928), dismissing writ of error from Wilcox v. Madison, 106 Conn. 223, 137 Atl. 742 (1927), which followed as *res judicata* Wilcox v. Madison, 103 Conn. 149, 130 Atl. 84 (1925).

[81] Saltonstall v. Board of Review, 132 Mich. 196, 93 N.W. 246 (1903); State v. O'Brien, 89 Mo. 631, 1 S.W. 763 (1886). See cases, including a minority *contra*, collected in Cooley, *Taxation* (4th ed., 1924), Vol. I, §284.

Broad considerations of policy are likely to influence the attitude of assessors toward this problem of alternative or future uses, whether they fully recognize the fact or not. Thus, during the period when a forest owner must pay taxes upon a stand of growing timber before he can sell it, assessors may lighten his burden by failing to take full account of the potentiality of future profit.[82] But land held idle in the suburbs of a city for purposes of speculation is not likely to be accorded similar indulgence.

Assessment at Reproduction Cost or at Earning Power.

Not only under the standardized methods of urban assessment but also under the "judgment methods" of rural assessment, the general practice throughout the country has been to base the valuations in large measure on crude estimates of replacement cost minus arbitrary or conventional deductions for depreciation. As every appraisal expert knows, the result of this tendency has been relatively to undervalue new and well-adapted improved properties and relatively to overvalue old or run-down or ill-adapted properties. In an early section of this chapter,[83] the point was made that this result may be defended under one version of the benefit theory of taxation—not because it portrays "true value," but because the costs of property may conceivably serve better than values as an index of the relative burdens that the property imposes on the government. But such a defense is not acceptable to doctrinal law, which insists that value *and not* cost is the proper tax base. The question arises, therefore, how far the courts will go in upsetting an assessment based on replacement cost, when the taxpayer presents convincing evidence that the property is worth materially less.[84]

[82] This has been true in New York, as an administrative practice, and in other states is sanctioned by statute. Report of Special Joint Committee on Taxation and Retrenchment (1922), N.Y. Legislative Documents, No. 72 at pp. 160–161. In L. Maxcy, Inc. v. Federal Land Bank of Columbia, 111 Fla. 116, 150 So. 248 (1933), the constitutionality of a statute providing that for purposes of taxation all nonbearing fruit trees should be disregarded was upheld on the flimsy ground that it involved not an exemption but a postponement of the tax.

[83] See *supra* pp. 459–460.

[84] The taxpayer here labors under the difficulty of presenting legally "convincing evidence," not merely that the property was worth less, but also that it was worth some specific amount less. Ordinarily, that is, he must go forward with his own proof of value and not rest content to cast doubt on the assessor's valuation. Usually he will try to establish his lower value either by adducing actual recent sales of the very property in question, or of similar property, or else by capitalizing the earnings of the business that is located on the premises. Each of these alternatives is fraught with difficulties. A court may belittle the sales on the ground that

The tendency of the courts to recognize the advantages of crude, wholesale appraisals and to give the assessors the benefit of the doubt in contested cases makes it impossible to answer this question save in very general terms. Replacement-cost assessments are most likely to be upset in extreme cases, where property is especially designed for a business that has no reasonable prospect of earning any net income. This was the situation with respect to a railroad which, though recently and expensively built, showed annual operating deficits and had defaulted on its bonds. In this case,[85] Judge Peckham (then a New York judge, later of the Supreme Court) sharply denied the validity of an assessment in excess of "the value of the property taken as farm property, and with the cost of the rails as old iron added." The right of way, he said, "must necessarily be of little or no value as a railroad."

But full reproduction cost is likewise inappropriate as a measure of value in the case of property dedicated to a business which, while solvent, cannot earn a fair return on that cost. Such a business, to be sure, would not liquidate its property at scrap value, but it would, on the other hand, be much better off than it is in fact if it could sell its property at reduction cost. The assets of this business, if not readily adaptable to other use, should be assessed at something less than reproduction cost and something more than scrap value, the exact point depending on just how near zero the anticipated earnings are.

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they may have been nonrepresentative or even inaccurately reported. As to capitalized earnings, they are generally held not to measure the value of the real estate, since at best they measure what the business enterprise was worth and not what the real property was worth. But capitalization of earnings has been sometimes regarded as a legitimate check on the reasonableness of the assessor's valuations even under the general property tax. People ex rel. Powers v. Kalbfleisch, 25 App. Div. 432, 49 N.Y. Supp. 546 (4th Dept., 1898).

Another obstacle raised by the courts against the acceptance of low valuations based on capitalized earnings is, on the one hand that *realized* earnings may not represent future earnings, and on the other hand that *future* earnings cannot be estimated with confidence. As to the capitalization of *realized* earnings see People ex rel. Mid-Crosstown Ry. v. State Tax Commission, 192 N.Y. Supp. 388 at 393 (Sup. Ct., 1921), where the road was assessed under the franchise tax but where the valuation of the tangible property was based on property-tax principles. Judge Lehman remarked here that "It is only where the railway not only is not earning any fair return on the cost of reproduction, but is not capable of earning such return, that the cost of reproduction is not a true criterion" (at 392). He added that, even in the latter case, it might be best first to ascertain replacement cost and then to make "a sufficient allowance" for "depreciation and obsolescence."

[85] People ex rel. Boston, H.T. & W.R.R. v. Wilder, 3 N.Y. St. Rep. 159 (Sup. Ct., 1886). The same judge, in People ex rel. Western Union Telegraph Co. v. Dolan, 126 N.Y. 166, 27 N.E. 269 (1891), held that a highly profitable telegraph line could not be assessed for more than the reproduction cost of its tangibles.

Here it is that courts have been slow[86]—and assessors much slower—in modifying the reproduction-cost figures resulting from standardized methods of assessment. A judicial tendency to require such modifications in a clear case is, however, indicated by a recent New York decision.[87] A hotel, lavishly built to enhance the prestige of the college with which it was associated, had been assessed at full reproduction cost despite proof that it was far too large for the community and rarely had enough guests to make both ends meet. The court, citing the *McAnarney* insurance case[88]—which since 1928 has been made to do duty in many fields of valuation—reduced the valuation by one-third. Due consideration should be given, it said, both to cost and to the satisfaction of the owner's desire for prestige, but the unprofitableness of operation must also be considered. Why the reduction should be in precisely the amount reached, the opinion as usual failed to state.

IV. The Assessment of Part of a Larger Property.

A building is bisected by a county line. A prosperous water company, doing business in East County and West County, has its reservoir in the former and its purifying plant and offices in the latter.[89] These two illustrations, like the more familiar one of a railroad traversing five or six states each of which can lay claim to jurisdiction over

[86] For example, Eminence Distillery Co. v. Henry County Board of Supervisors, 178 Ky. 811, 200 S.W. 347 (1918); National Lumber & Mfg. Co. v. Chehalis County, 86 Wash. 483, 150 Pac. 1164 (1915) (*semble*). The taxation of railroads under the special taxes applicable thereto affords an interesting analogy—reproduction figures have often been given considerable weight by tax commissions even when they have been far in excess of a capitalization of the earnings of a line and of the aggregate value of its securities: Chap. XVIII. Note also the weight frankly given reproduction-cost figures as against undisputed expert opinion in St. Louis Electric Bridge Co. v. Koeln, 315 Mo. 424, 287, S.W. 427 (1926); *cf.* the same case, People v. St. Louis Electric Bridge Co., 290 Ill. 307, 125 N.E. 280 (1919).

[87] People ex rel. Colgate Inn, Inc. v. Assessors of Town of Hamilton, 132 Misc. 506, 230 N.Y. Supp. 134 (Sup. Ct., 1928). The court cited People ex rel. Powers v. Kalbfleisch, 25 App. Div. 432, 49 N.Y. Supp. 546 (4th Dept., 1898), cited *supra* note 84, which had relied upon low earnings along with low reproduction cost in overturning an assessment based upon original cost, and in so doing reaffirmed the declaration of a still earlier case that "A thing to be worth its cost, must be able to pay out of the profits from its use and enjoyment, an income bearing some relation to the income due from an investment or loan of a sum of money equal to such cost, and over and above the loss by wear or waste." People ex rel. Ogdensburgh & L.C.R.R. v. Pond, 13 Abb. N.C. 1 at 7 (Sup. Ct., 1882).

[88] McAnarney v. Newark Fire Ins. Co., 247 N.Y. 176, 159 N.E. 902 (1928).

[89] *Cf.* Blackstone Manufacturing Co. v. Inhabitants of Blackstone, 200 Mass. 82, 85 N.E. 880 (1908).

part of its physical plant and *part* of its sources of freight and passenger traffic, present one of the most difficult problems in the field of taxation. We mention it here only with reference to the assessment of ordinary real estate. But the infrequency with which the issue arises and the absence of reported cases rule out a detailed discussion.

Obviously, if the assessors of our building were to attempt to value each half on the basis of its separate liquidation price, the property would be nearly tax exempt. Like one glove or half a fountain pen, each part alone may be almost valueless. So, too, though our water company is a valuable business organism, the sum of what would be received from separate sales of the assets on each side of the county line would be ridiculously small.[90] On the other hand, it is equally unjust for the assessors to value the part within their jurisdiction at just a little less than the whole, on the theory that the owner would lose the whole if either part were destroyed. This practice would result in a combined assessment of the entire property at almost twice its full value.

Since the parts are arbitrarily divided, not according to any economic considerations, but by the haphazard crossing of geographical lines, the allocation of value to these parts must, in the nature of things, be arbitrary. No one "right" method of solution exists, because the problem is an artificial one. That is not to say, however, that certain methods of allocation do not commend themselves as on the whole more feasible or reasonable than others. The problem will be discussed at length in Chaps. XIX and XX, on the so-called "unit rule" of tax valuation.

The Assessment of Partially Exempt Property.

Arbitrary division of the value of a whole is required in other taxing situations besides the one just discussed.[91] For example, although a piece of property is wholly within one jurisdiction, it may be partially taxable, partially exempt. The common situation is that of nonexempt property incorporated with exempt property in a single unit whose value is greater than the sum of the values of its parts. Thus, in a

[90] To postulate some sort of value particles which, like the ions of electricity inhere in all parts of the physical property, as suggested by such cases as Union Water Power Co. v. City of Auburn, 90 Me. 60, 37 Atl. 331 (1897), is a rank myth, equally untrue of property's liquidation price and its value in use. The concurring opinion in the Maine case takes the equally fallacious position that each half of the property holds a point of vantage which enables it to claim a market value of one-half the whole value.

[91] State v. Abbott, 42 N.J.L. 111 (1880), is an interesting case on the border line between geographical apportionment and exemption problems.

city block where normal 25-foot lots have a value of $5,000, while a 50-foot lot, because of the advantage of plottage, has a value of $11,000, a taxpayer may own two contiguous lots of which one is exempt. Shall his property be assessed at $5,000, or at $6,000, or at some intermediate figure?

A formula sometimes stated as applicable to the valuation of partially exempt property is derived from one of the two alternative rules in eminent domain relative to partial takings: The value of the whole parcel less the value of the part exempt equals the value of the part taxable.[92] This calls for a $6,000 assessment. On a somewhat different theory the assessors of the city of Cambridge, in assessing a six-story building owned by Harvard University of which the two lowest floors were rented out for commercial purposes while the upper four stories were used as tax-exempt dormitories, taxed the University on the full value of the lot with a two-story building.[93] They simply treated the upper floors as nonexisting, which is a different procedure from subtracting the value of the exempt dormitory accommodations—since the dormitories were assuredly not suspended in mid-air. The county commissioners reduced the assessment to half the value of the lot and one-third the value of the six-story building, and this was sustained on appeal.

While cases like this last present seeming analogies to geographical allocation, they differ in one vital respect. The question as to how much can be taxed by one of two taxing jurisdictions is not finally answered by an interpretation of the tax statute. But the question as to how much property shall be exempt can be—although it is not always—determined by the framers of the constitutional or statutory exemption provision. One must first look there to see the extent of the exemption, having in mind that exemptions ordinarily are narrowly construed.[94] A bare exemption of property, therefore, may properly be read as including none of the excess value created by aggregating the property with nonexempt property into a larger unit. In harmony

[92] See, *e.g.*, City of Auburn v. Y.M.C.A., 86 Me. 244, 29 Atl. 992 (1894) (official headnote); 61 C.J. 646. The eminent-domain rule is that the value of the whole minus the value of the part remaining is the amount recoverable. See *supra* p. 422. This is fair enough, for the condemner *does* deprive the owner of everything except the residual value. But in the tax case there is no actual separation, only a theoretic apportionment of value.

[93] City of Cambridge v. County Commissioners, 114 Mass. 337 (1874). Other examples of allocation, by one method or another, are Rohrbaugh v. Douglas County, 76 Neb. 679, 107 N.W. 1000 (1906) (area); County Commissioners v. Sisters of Charity, 48 Md. 34 at 43 (1878) (capitalization of income).

[94] *Cf.* Worden v. Oneida County, 35 App. Div. 206, 54 N.Y. Supp. 952 (4th Dept., 1898).

with the principle that excess composite values should not be allocated, an office building erected upon valuable exempt land in the heart of the city has been held taxable only at reproduction cost, on the theory that the location advantage is part of the value of the unimproved exempt land.[95] On the other hand, an exemption statute *may* call for allocation. This is the case, for instance, when the statute impliedly says that so much of a house and lot shall be exempt as is used for dormitory purposes.

Exemptions have a value—a capitalization of the amount of the tax annually saved. In a valuation of partially exempt property for any purpose other than taxation, this element of value would probably be taken into account. But it may fairly be disregarded for taxing purposes. Suppose that a city ordinance allows a perpetual tax exemption, to the extent of $1,000 per room, on all new dwelling houses erected during a certain period. *A* owns two houses, identical in every respect except that one is entitled to a $10,000 exemption. Assume that buyers would pay $20,000 for the first house, and, because of the exemption, $24,000 for the second. If the second house were assessed at $14,000, *i.e.*, at the $24,000 market value minus the $10,000 exemption, then the exemption would be reduced to $6,000. Such an assessment would not only be unfair; it would result in contradiction of the premise upon which it was based. For, if in reality only $6,000 were exempted, buyers would not pay a full $24,000 for the house. Here we have an illustration of the necessity of different valuations for different purposes. For taxation the house should be valued at $20,000; for various other purposes, at $24,000.[96]

The Extent to Which the General Property Tax Takes Cognizance of Separate Legal Interests in Real Estate.

Real estate is commonly split up into separate legal interests held by different persons—mortgagor and mortgagee, landlord, tenant, and subtenant, holders of various easements over the land, and so forth. Here, too, one would think, an allocation problem is presented; for if these legal interests are regarded as so many separate properties, must not the unitary value of the physically undivided land be apportioned

[95] Tulane Improvement Co., Ltd. v. Board of Assessors, 121 La. 941, 46 So. 928 (1908).

[96] In an analogous situation, the effect of different tax burdens on property of similar productivity has been taken into account in valuation for the property tax. Land in one school district was subject to higher school rates than land in an adjacent district. As the net income derived from land in the first district was reduced, and net income is a proper factor to be considered, the assessment was reduced. Schmidt v. Saline County, 122 Neb. 56, 239 N.W. 203 (1931).

among them? Contrary to expectation, the answer is that the general property tax ordinarily pays no attention to these divisions of interest and assesses the property as if it were owned in fee simple. Yet even the property tax stops short of *totally* disregarding the partial legal interests.

John Doe is the owner of a house and lot. He conveys an easement to his neighbor, Richard Roe. He mortgages the property to a local bank. He executes a 10-year lease to John Doe, Jr., at the rental of $1 a year. Then assessment time arrives, and he finds himself assessed on the full value of the land. He prepares a petition in abatement, setting forth that the three acts have greatly lessened the value of his property. His petition will be denied as to the lease and the mortgage, but may be granted as to the easement. It is well settled at common law, and rarely changed by statute, that the mortgagor[97] and the lessor[98] pay the entire tax on the property as if there were no mortgage or lease, and that the life tenant pays the entire tax just as if there were no remainderman.[99] But it has also been held that a landowner whose property is subject to an easement is entitled to a reduced valuation, the value of the easement being added to the estate of the dominant owner.[100] When a piece of property is so encumbered with easements that no use can be made of it, the fee owner pays no tax.[101] What is true of easements is true also of covenants binding the land.[102]

[97] Paddell v. City of New York, 50 Misc. 422, 100 N.Y. Supp. 581 (Sup. Ct., 1906), *aff'd*, 114 App. Div. 911, 100 N.Y. Supp. 1133 (1st Dept., 1906), *aff'd*, 187 N.Y. 552, 80 N.E. 114 (1907), *aff'd*, 211 U.S. 446 (1908); In re Rolater, 67 Okla. 215, 170 Pac. 507 (1918). The taxation of the land of the mortgagor does not, of course, exempt the mortgage notes as personalty of the mortgagee.

[98] Donovan v. Haverhill, 247 Mass. 69, 141 N.E. 564 (1923). Where the landlord is the municipal, state, or Federal government, the lessee's interest may be properly assessed to the tenant. Hammond Lumber Co. v. Los Angeles County 104 Calif. App. 235, 285 Pac. 896 (1930). Metropolitan Building Co. v. King County, 62 Wash. 409, 113 Pac. 1114 (1911). See 24 *Col. L. Rev.* 324 (1924).

[99] See Pike v. Wassell, 94 U.S. 711 at 714 (1876). This must not, however, be carried too far by analogy. *Cf.* Brooke v. Norfolk, 277 U.S. 27 (1928).

[100] Tax Lien Co. of New York v. Schultze, 213 N.Y. 9, 106 N.E. 751 (1914).

[101] People ex rel. Topping v. Purdy, 143 App. Div. 389, 138 N.Y. Supp. 569 (1st Dept., 1911), *aff'd*, 202 N.Y. 350, 95 N. E. 1137 (1911). *Cf.* People ex rel. Poor v. Wells, 139 App. Div. 83, 124 N.Y. Supp. 36 (1st Dept., 1910), *aff'd*, 200 N.Y. 518, 93 N.E. 1129 (1910).

[102] Lodge v. Swampscott, 216 Mass. 260, 103 N.E. 635 (1913). See 24 *Col. L. Rev.* 324 (1924). In some situations it is not easy to determine whether the analogy of the lease or of the easement applies here. *Cf.* the eminent-domain cases of People v. Canal Appraisers, 13 Wend. 355 (N.Y., 1835); Velte v. U. S., 76 Wis. 278, 45 N.W. 119 (1890). Special problems arising under the English rating system, such as the effect of a "tying" covenant (see Assessment Committee v. White [1898] 2 Q.B. 630) need not concern us.

Whether these methods of assessment are to be explained on historical or on other grounds, is immaterial for the principles of valuation. They can be justified practically on the ground that the number of assessments is reduced to a fraction of what they would otherwise be, and also that difficult problems of allocation of values are avoided. Why the easement should have received exceptional treatment we are unable to say.

The proper deduction from the value of the servient estate and the proper addition to the value of the dominant estate are determined largely by the opinion of real-estate experts, aided by occasional selling prices, since easements are sometimes the subject of separate sale. One should note that there is no necessary equivalence between the damage a landowner suffers by being subjected to an easement and the benefit other land obtains from that easement. An easement of passage over *A*'s forest land to the road may greatly enhance the value of *B*'s hotel property without correspondingly depreciating *A*'s land; while on the other hand an easement of light over *C*'s lot may merely make *D*'s backyard slightly pleasanter while preventing *C* from building an apartment house.[103]

V. Undervaluation and Resultant Problems in the Equalization of Assessments.

Before the pending business depression, one of the strangest characteristics of the property tax, and its most striking departure from the standard of market value, was the all but universal prevalence of percentage or partial valuations—that is to say, valuations known to be only a percentage of what the property would bring in the market. Occasionally the use of fractional valuation is even sanctioned by statute.[104]

Theoretically the taxpayer's pocket is not in the least affected by uniform undervaluation or overvaluation. Systematic undervaluation diminishes the tax base, and the tax rate must therefore rise in order to supply the required government revenue. Similarly, the

[103] No decisions under the property taxes have been found dealing with valuation of easements.

[104] Justice Pitney tells us in Greene v. Louisville & I.R.R., 244 U.S. 499 at 516 (1917): "A few of the states have enacted laws adopting percentages of full value as bases of taxation: Iowa, 25 per cent. (Code Supp. 1907, §1305); Illinois, 20 per cent. (Hurd's Stat. 1898, p. 1365, e.), afterwards 33⅓ per cent. (Hurd's Stat. 1909, p. 1882, §312; Hurd's Stat. 1912, p. 1963, §312); Nebraska, 20 per cent. (Rev. Stats. 1913, §6300); Alabama, 60 per cent. (Gen. Acts 1915, p. 393, §9)." For a long discussion of expert evidence as to undervaluation practice in Illinois, see Mobile & O.R. Co. v. Schnipper, 31 F. (2d) 587 (1929).

tax rate may be reduced by enlarging the tax base through overvaluation.

There are several reasons for the persistence of partial valuation. Gullible taxpayers associate a larger valuation with a larger tax, or at any rate are less contentious about a relatively excessive assessment if it does not exceed their estimate of true value. The ability to maintain a stable rate and to increase revenue by tampering with the tax base—a change which calls for less publicity and less opposition—is naturally desired by the party in power. Occasionally, partial valuation is intended as a substitute for a varied system of rates; *i.e.*, different forms of property, while nominally taxed at the same rate, are in fact taxed at differing rates by being assessed at different proportions of full values.[105] Undervaluation of realty is sometimes justified as compensating for the elusiveness of personalty; but even if the latter is assessed fully when caught, experience has shown that the net result is to furnish an additional incentive for evasion.

Another inducement to undervaluation has been that, since the state relies on the property tax for part of its revenue, the county assessors seek to lighten their constituents' burden at the expense of the rest of the state by assessing the local property at a lower percentage than is applied elsewhere. This process has often resulted in a competition between counties as to which could most nearly approach the limit of nominal valuation. With the increasing trend in some states toward reserving the property tax for the support of the local communities, and in other states toward the creation of state boards of equalization, the enthusiasm for percentage valuation has been dampened. Moreover, an increasingly potent force impelling toward full valuation is the fact that the debt limit of many cities is fixed by reference to the assessed value of property within their jurisdiction.

The objections to the practice of undervaluation are patent. In the first place, except where sanctioned by statute, it involves a generally known and sanctioned disregard by officials of the law requiring them to assess property at its full and fair value. The other great vice is that the percentage of undervaluation is rarely a matter of common knowledge, so that it is extremely difficult to ascertain whether there is uniformity in the proportion or whether, through incompetence, favoritism, or corruption of the assessors, some portions of the taxpaying body are bearing the others' burdens, as between either individuals or local groups.

[105] In re Delinquent Real Estate Taxes, 149 Minn. 335, 183 N.W. 671 (1921), the unplotted land was under the statute assessed at one-third of its value, the plotted land at 40 per cent.

Constitutional Mandate of Uniformity.

In combating the evils resulting from undervaluation, the courts have relied largely on the constitutional provisions calling for uniformity and equality of taxation. According to Cooley's standard work,[106] such provisions may be found in the constitution of every state except New York, Connecticut, and South Dakota.

The provisions fall into two groups. In the first are highly generalized principles, such as the expression that "the burdens of the state ought to be fairly distributed among its citizens," and three very common clauses requiring property taxes to be, respectively, "uniform," or "uniform and equal," or "uniform upon the same class of subjects." In the second and more specific group are the many variants of the requirement that taxes should be "*in proportion to* value," value being defined in some such terms as "full cash value" or "market value."

Both groups have been interpreted in the same way by judges in their decisions and usually by legislators in their statutes. They are regarded as requiring that all property in the state subject to the general property tax be taxed at the same rate of levy and in the same proportion to full value, such value being determined as nearly as practicable in a uniform manner. If land is taxed at 2 per cent, bonds should be taxed at the same rate. If farmhouses are assessed at 60 per cent of their true value, vacant urban lots held for speculation should likewise be assessed at 60 per cent. To the effect of this doctrine on undervaluation, especially in the light of its conflict with the rule of full valuation, we turn in the next section. But here we may note that the interpretation of the constitutional clauses has another fundamental implication for the taxing system.

States where the provision is of what we have called the second type, quite naturally interpret it as leaving no alternative to collection of a constant percentage of the value of all property. But states having only a clause of the first type need never have committed themselves to such a highly formalistic notion. Uniformity does not require unvarying treatment of all the differing categories of property; indeed, true uniformity is inconsistent with such inflexibility. Some kinds of property are easier to hide than others; the owners of some are better able to shift the tax than the owners of others, or better able to bear the exaction whether or not it can be shifted. These variables could be adjusted by use of varying rates, exemptions, bases other

[106] Cooley, *Taxation* (4th ed., by Clark A. Nichols, Chicago, 1924), Vol. I, Sec. 252. Cooley gives numerous citations of the constitutional clauses in question: Sec. 253.

than value, progression, classification, and so forth. To tie the legislators' hands by making taxation according to value mandatory, and still worse to confine them to a single rate upon that value, defeats the objects of justice and expediency. Uniformity does not require anything more than the treatment alike of things that are alike. How to classify and how to treat the different classes should be questions for the legislators' discretion.[107]

Nevertheless, the interpretation requiring the taxation of all property at the same rate and on the basis of relative value is still strongly intrenched. It must usually be defeated by indirection—by the evolution of new taxes, not judicially regarded as property taxes and therefore not subject to the constitutional restrictions. With one great class of such taxes we shall deal in the following chapter. For the present we return to the effect of the constitutions upon undervaluation practices.

Undervaluation Discriminating Against Individuals: Uniformity Preferred to Full Value.

If in a given state there is a 2 per cent levy on assessed valuations, every one of which is at 50 per cent of market value, the desired uniformity of taxation obtains. But what if one taxpayer comes into court offering to prove that, although property in general has been appraised at 50 per cent of its full value, *his* property was assessed at 100 per cent? On the one hand, he obviously bears more than his fair share of the tax burden; but on the other hand, his assessment is exactly what, by the express provision of the statutory (and usually the constitutional) rule of valuation, the assessor is directed to arrive at—full value. Every assessment is out of step except his. Should courts fly in the face of their constitutions and statutes and order the assessors to cut the valuation of this taxpayer to one-half of what they are sworn to find? Or should they choose the other alternative of commanding the officials to assess all property at its full value?

Raised by a taxpayer's suit to enjoin the collection of taxes based upon any higher proportion of true value than is prevalent in the community, the question has vexed the courts of every state. Since constitutional clauses are involved, court review of the administrative

[107] "With the complications of civilized society, the stress of taxation is not, and cannot be confined to the individual who pays the tax; its ramifications are widespread and hidden. This and other considerations forbid the assertion of any specific theory as essential to just taxation." State v. Travelers' Insurance Co., 73 Conn. 255 at 261, 47 Atl. 299 at 301 (1900). A good illustration of the effect of the equality clauses of state constitutions may be found in Opinion of the Justices, 220 Mass. 613, 108 N.E. 570 (1915).

action is easy to obtain, even after an unfavorable decision upon the issue by an administrative board of equalization. Formerly the state courts divided on the question thus presented; some granted the desired relief, others held themselves precluded by the letter of the law from doing more than advise the complainant that he had the theoretically satisfactory privilege of suing out a writ of mandamus to compel the assessors to revalue every other piece of property in the jurisdiction.[108] But since the matter has now been set fairly well at rest by decisions of the Federal courts, we shall confine ourselves to these.

The first important case was *Cummings v. Merchants' National Bank.*[109] The bank was taxed by the Ohio county authorities upon the full value of its shares. Assessors in Ohio, intending to discriminate against bank shares, had agreed to assess realty and all other personalty at one-third their value. The Ohio constitution provided that the property tax should be by a uniform rule and according to full value. The complainant paid one-third of the taxes claimed, and the Circuit Court enjoined further collection proceedings against it. This decree was affirmed by the Supreme Court. Although the bank got into the Federal courts by virtue of its national incorporation, the decision was not based upon the Congressional statute protecting national banks against discrimination. Instead, it proceeded upon an interpretation of the state constitution. Justice Peckham took it for granted that the state constitution embodied the mechanical-uniformity ideal, and on this basis the lower court's injunction against collecting the full tax was affirmed. Reinforced by Circuit Judge Taft's elaborate opinion in *Taylor v. Louisville & Nashville Railway Co.*,[110] which got into the Federal courts on the ground of diversity of citizenship and which concerned the tax system of Tennessee,[111] the *Cummings* decision exerted a powerful influence upon the construction of state constitutions, not only in the Federal courts, but also in the state courts.

Raymond v. Chicago Union Traction Co.[112] raised the further question whether the taxpayer could complain of a violation not merely of the state but of the Federal Constitution on the ground that the assessor's action deprived him of his property without due process and denied him the equal protection of the laws. Here, for the first time,

[108] See discussion of the leading early state decisions pro and con in Taylor v. Louisville & N.R. Co., 88 Fed. 350 at 365–369 (1898).

[109] 101 U.S. 153 (1879).

[110] 88 Fed. 350 (1898).

[111] Under a later statute the Tennessee court refused to follow the Cummings and Taylor cases. Carroll v. Alsup, 107 Tenn. 257, 64 S.W. 193 (1901).

[112] 207 U.S. 20 (1907).

the facts did not show diversity of citizenship or any other grounds of access to the Federal court except the alleged violation of the uniformity provision in the Fourteenth Amendment. The injunction was granted. The language of the majority opinion and of the subsequent opinions in *Sioux City Bridge Co. v. Dakota County*,[113] and in *Bohler v. Callaway*,[114] is to the effect that willful discrimination in the percentages of valuation under a property tax violates the Fourteenth Amendment. But an analysis of these cases shows that a uniformity provision was in the state constitution, while the full-value provisions were merely statutory, so that there was no necessity of a choice between conflicting constitutional provisions. In *Greene v. Louisville and Interurban Railroad Co.*,[115] the full-value provision as well as the uniformity one was in the state constitution. The Court preferred to base its decision upon an interpretation of the state constitution rather than upon the alleged Federal question.

The present state of the law, then, is this: The Federal decisions, first as a matter of construction and then as a matter of Federal constitutional requirement, established the rule that "where it is impossible to secure both the standard of the true value, and the uniformity and equality required by law, the latter requirement is to be preferred as the just and ultimate purpose of the law."[116] This is subject to the qualification that there is no square decision that, if the state constitution were to make itself unmistakably clear that in case of conflict the desideratum was full value for some rather than equality for all, this would violate a Federal right; but the dicta tend so strongly in the affirmative that the question can hardly be considered open.

To the general rule there is one highly important restriction, illustrated by *Sunday Lake Iron Co. v. Wakefield.*[117] Here the taxpayer's property was in all probability assessed relatively higher than other property in the state. But the assessment was not shown to have been due to any intent to discriminate. Said the Court:

> It is also clear that mere errors of judgment by officials will not support a claim of discrimination. There must be something more—something which in effect amounts to an intentional violation of the essential principle of practical uniformity. . . . The burden of proof is upon the complaining party.[118]

[113] 260 U.S. 441 (1923).
[114] 267 U.S. 479 (1925).
[115] 244 U.S. 499 (1917).
[116] Sioux City Bridge Co. v. Dakota County, 260 U.S. 441 at 446 (1933).
[117] 247 U.S. 350 (1918).
[118] *Ibid.* at 353.

This means that a taxpayer in such a situation has no constitutional right to redress. Statutes establishing equalization boards, however, may grant him administrative protection, and sometimes he is given access to the courts.[119] Some decisions, in states not so providing, try to escape the limitation of court review to intentional inequality by an overreadiness to find intent where there was only accident or ignorance. Other courts veer to the opposite extreme. It should further be remembered that the taxpayer must always show his assessment to be higher than the average of assessments in the community, not merely higher than those of some other individual. How to prove this is often a difficult problem.

Undervaluation Affecting Communities: Procedure of Boards of Equalization.

Assessment of an individual at a higher rate than that of his neighbors is only one of the kinds of inequality resulting from the practice of undervaluation. As already said, one of the motives of the practice is the attempt to gain advantage for a whole community at the expense of the rest of the state or county by assessing all property therein at a lower rate. So widespread is this attempt, that it has almost everywhere called into being administrative correctives in the form of boards of equalization. While such boards are sometimes given jurisdiction over individuals' complaints, their characteristic function is to adjust the relations between localities or classes of property.[120]

The county equalization boards hear contests between townships, and the state boards hear contests between counties. The word "contest" is appropriate even though these boards usually meet to consider and adjust the assessment without anybody's having made formal complaint, because there is in actuality a constant, hard fight on the part of the board members to win advantage for their localities.

A board's first duty in considering the assessment roll is to find at what proportion of "true value" the average assessments in each

[119] Under the New York system of direct court review, valuations may be reviewed "if unequal in that the assessment has been made at a higher proportionate valuation than the assessment of other property on the same roll by the same officers." New York Tax Law (1909) §290.

[120] See Campbell v. Minnehaha Nat. Bank, 11 S.D. 133, 76 N.W. 10 (1898). As to how far they may prevent the escape of property from the rolls so as to produce equality, compare Farmers & Merchants Bank v. Board of Equalization, 97 Calif. 318, 32 Pac. 312 (1893), with State v. Cunningham, 153 Mo. 642, 55 S.W. 249 (1900).

locality have been made. Upon the accuracy of this first step all the rest depends. This highly important inquiry is largely determined by guesswork, or, worse, by political logrolling. This is necessarily so, for nobody knows the "true value" of the property in each locality. The board cannot revalue all the property; at most it can investigate representative samples in different localities, or hear the evidence of interested parties on the subject. In so far as the undervaluation has been intentional, each assessor knows the percentage of true value which he tried to find, but if he has local interests at heart, he will conceal the undervaluation as far as possible, and in any event he may have departed considerably from the percentage he had in mind. The boards meet informally, they are not usually required to hear witnesses (it being assumed that the members can supply each other with information about their localities), their proceedings are usually unrecorded, and court review of their decisions is hard to obtain.[121]

The methods of correction, after the board has found the supposed percentage of undervaluation, vary from state to state. In some, the "true values" as found are substituted for the original assessments. In others, the assessments for the year are left undisturbed, but corresponding additions or subtractions are made from the next year's valuations. Still other states, while not disturbing the total assessed valuation of lands in the county, add to or subtract from the assessed valuations of the towns until each town's equalized value bears the same relation to its true value that the total assessed value of the towns bears to their total true value.[122]

VI. The Assessment of Personalty.

The annual tax upon the assessed value of individual parcels of real estate is the oldest and best-known American tax. Yet one seldom finds a tax thus restricted by statute. Indeed, the states solemnly levy a tax, called the *general* property tax, upon all property in the state, and then exempt certain types of personalty by statute, stand passively by while almost all of the remainder is withheld from the

[121] Fields v. Russell, 38 Kan. 720, 17 Pac. 476 (1888), illustrates the judicial attitude; Foster v. Rowe, 128 Wis. 326, 107 N.W. 635 (1906), illustrates the legislative recognition of the need for freedom.

[122] In the preparation of this section, acknowledgments are due to an unpublished Harvard thesis in administrative law: Isador Levinson, "The Administration of Taxation in New York State through the State Tax Commission" (June, 1925). See also a "Report on Assessment and Equalization of Real Estate for Taxation in New York," by the National Institute of Public Administration, Memorandum 3 of the Report of the New York State Commission for the Revision of the Tax Laws (Albany, 1932).

assessment rolls with the tacit approval of their officials, and permit absurd undervaluation of the residue.

This situation is neither new nor distinctively American. Professor Seligman has found an escape of personal property from actual taxation in the Athenian, Roman, and medieval European fiscal systems.[123] The development of the English general property tax bears a particularly strong resemblance. As far back as 1166 there was a tax upon lands and movables, and by 1334 this had become standardized as a levy of one-tenth of the capital value of personalty and one-fifteenth of the annual rental of lands. Already in the thirteenth century it was considered an unusual thing to tax personalty upon its full value; and in 1592, not five men in London were assessed at as much as £200 upon their goods.[124] A series of judicial decisions beginning in 1633 so restricted the definition of taxable personalty that "intangible personalty, tangible personalty kept in the owner's hands, earnings from personal abilities, and profits from moneys invested or lent at interest in another parish were exempt as being either unproductive, invisible, or not possessing a local situs." For the last eight decades all personalty has been by statute "exempted" from the "general" property tax.[125]

The escape of personalty from the general property tax in America is as old as the tax itself. In New England, which adopted this tax while the other colonies were still relying for revenue upon indirect taxation of commerce and of the privilege of engaging in occupations, there was official complaint in 1657 "that visible estates in land, corne, and cattle, are, accordinge to order, wholly & fully taxed, but the estates of merchants, in the hands of neibours, straungers, or theire factors, are not so obvious to view, but, uppon search, little of theire estates doe appeare, being of great valew."[126] Despite sporadic efforts to change the situation, personalty has won more and more immunity from the general property tax, partly by statute and partly by evasion.

Because personalty so largely escapes the general property tax, few principles of valuation can be gleaned from tax cases. Several classes of personal property nevertheless come under the tax often enough to merit short comment.

[123] E. R. A. Seligman, *Essays in Taxation* (10th ed., 1928), Chap. 2.

[124] Stephen Dowell, *History of Taxation and Taxes in England* (2d ed., London and New York, 1888), pp. 1, 68; Seligman, *op. cit.*, p. 46.

[125] Seligman, *op. cit.*, pp. 53–54.

[126] *Records of the Governor and Company of the Massachusetts Bay*, edited by N. B Shurtleff (Boston, 1853), Vol. III, p. 221.

Assessors while inspecting the land sometimes assess the personal property upon the land and associated with its use. This seems to be far more true of cows and plows in country districts than of furniture in the city. Where furniture in city homes is assessed at all, very low valuations are generally found by the assessors. Theirs is the natural feeling that the owner unlucky enough to be singled out for taxation at all should at least have his sentence lightened by the lowest possible assessment. To this end, the taxpayer is advised to place such a value upon his personal property as he thinks it would "sell for"—in a secondhand market, of course. This tendency of administrative practice, widespread although not confirmed by specific statute and decision as far as we have been able to discover, is in line with the notion of "market value" accepted by the Wisconsin Supreme Court, and out of line therefore with both the theory and the practice of real-property valuations in most other jurisdictions.

Despite the general acquiescence in the escape of even tangible personalty, the effort still persists in some states to get at intangible property in such forms as stocks, bonds, notes, mortgages, and bank balances. It is thought by the courts of these states that the constitutional clauses requiring uniform taxation according to value are violated by the modern system (actually reaching more property and productive of more revenue) of permitting the registration of these intangibles at a low fee with consequent exemption from property taxes.[127] At best the effort to reach securities and the like under the general property tax is a feeble one, measurably successful only if the tax is retroactively enforced at the time of death, when safety boxes are opened up. Cases of the taxation of valuable contract rights may also be found, but they are yet more rare.[128]

The taxation of personal property employed in a corporate business, along with all other elements of value making up the value of the whole going concern, is left for discussion in the following chapter.[129] But the case of *State v. Halliday*,[130] which is often regarded as one of the

[127] Wheeler v. Weightman, 96 Kans. 50, 149 Pac. 977 (1915). For an enumeration of mortgage-recording statutes see dissenting opinion of Justice Brandeis in Louisville Gas Co. v. Coleman, 277 U.S. 32 at 47, n. 7 (1928).

[128] McGregor v. Ireland, 86 Kan. 426, 121 Pac. 358 (1912).

[129] Merchants' stocks of goods are sporadically taxed in some states under the general property tax, but here again we have found no judicial discussion. The truly interesting question in this connection would be whether the goods should be valued in the merchant's hands at his buying or selling price. The former valuation would seem proper in most cases and would conform to the usual rule in the law of damages. See Chap. XIII.

[130] 61 Ohio St. 352, 56 N.E. 118 (1899).

early precedents for going-concern taxation, properly belongs here, and is interesting enough to merit comment. The Ohio constitution said that all property was to be taxed according to its true value in money, and this was amplified by statute as follows:

> . . personal property shall be valued at the usual selling price thereof . . . and if there be no usual selling price known to the person whose duty it is to fix a value thereon, then at such price as it is believed could be obtained therefor, in money, at such time and place.

An Ohio telephone company rented its telephones from the taxpayer, a foreign corporation which manufactured them under a patent monopoly. The cost of manufacture was only $2.88, but the yearly rental was $14. Adding 20 per cent—the supposed fair manufacturing profit—to cost, the local assessor valued the instruments at $3.42. The state auditor, who enjoyed supervisory powers, ordered a valuation at $233, this being a capitalization of the $14 rental at 6 per cent, and brought mandamus to enforce the order. The court reasoned that the instruments had no selling price, within the meaning of the statute, because nobody other than the Ohio company, which was licensed by the owner, could use them without violating the patent monopoly.[131] In such a case, it said, a substitute process of valuation should be employed—namely, consideration of all factors relevant to the ascertainment of value. Original and reproduction cost, while ordinarily highly significant, were not under the circumstances entitled to much weight. The state auditor's method was held more nearly proper, since the income-producing capacity of an article, when known, has an obvious relation to its value. The case, however, was sent down for further proceedings before the assessor to correct the rate of capitalization of the rental, which was held unreasonable in view of the fact that the instruments lasted only a few years and therefore could not be valued as if they would go on producing income in perpetuity.

Because the approved method involved the capitalization of the earnings of the property taxed, a method usually associated with going-concern taxation, *State v. Halliday* might seem to belong in that

[131] The propriety of the court's assumption in respect to the license to use, and the corollary of this assumption—*i.e.*, that even though the owner commanded such a high rental only because of patent rights, nevertheless the state assessors could give consideration to the rental figure without deduction for the patent rights—we do not discuss, as outside our scope. The Ohio court was certainly correct in pointing out that many articles are legally valued at their current market price, despite the fact that this latter price is largely determined by patented features of the article.

category of taxation. But the difference is that capitalization was resorted to here to find the value of certain specific physical assets, rather than the value of the whole corporate enterprise of either the lessor or the lessee corporation.

Other interesting problems may be raised concerning the taxation of personalty; but in the absence of decisions, the answers must be a mere guess. For example, suppose that the quoted and effective price of coal in the hands of dealers equipped to make sales is $15 per ton; but that a consumer having a few tons of coal in his cellar would get only $12. If the government requisitioned this coal, $15 would be the owner's compensation, a converter would have to pay so much in damages, its destruction by fire would entitle the owner to so much insurance. But the owner himself could sell his coal for only $12, and it may be that this is decisive under a tax statute. Again, suppose the rather common case of bonds which are sold by a banking house for 100 with a standing offer to buy them back at 97; or the case of the occasional bond which contains a clause giving the holder an option to redeem at somewhat below par. If such bonds have a limited sale, the investor who desires to liquidate may find that the banking house or obligor is the best customer even though there have been sales by dealers at a higher price. Such intriguing questions, if they arise in practice, have never appeared in cases coming to our attention.

VII. Conclusions.

The confusion as to the meaning and measure of value that one finds in the administrative practice and in the judicial rulings on real-estate assessment is not the type of confusion that can ever be cleared up by the professional appraiser or by the value theorist. The trouble lies far too deep to be cured by either of these economic skin specialists. It lies in the absence of any valid philosophy for the general property tax or for the general real-estate tax. Only if and when the experts in public finance can answer the prior question, Why should all owners of real property pay the same rate of tax on the value of their property? will the value specialists have any premise from which they can derive a conclusion, say, as to whether "value" should be construed to mean replacement cost or market value. But all attempts to answer this prior question have so far broken down; and the hopelessness of the effort is now conceded by the most competent authorities in fiscal science.

It follows that what is needed is a reform of our whole system of real-estate taxation. One must begin, not with the question how real estate should be valued for tax purposes, but with the question why

real estate should be singled out for any special form of taxation. Certainly the ability-to-pay doctrine can no longer be adduced in support of a discriminatory burden on realty. Whatever force there may once have been in the argument that the total wealth of individuals corresponds roughly to the values of their houses and lots, has disappeared with changing economic conditions. If a real-estate tax can be defended, it must be supported on other grounds. The most plausible of these grounds are first, that suggested by the philosophy of the single tax, and second, that suggested by the probability that the expenses of local government grow more closely in proportion to real-estate development than in proportion to increments in other forms of private wealth. But the former theory requires the complete tax exemption of improvements on land, while the latter theory may possibly suggest the very contrary conclusion, namely, that only improvements be taxed, and that the tax be measured by such indices as relative costs, relative size, and character of construction, rather than by relative commercial values.

Fortunately for his peace of mind, the present writer is not a tax specialist and may therefore content himself with raising these baffling problems without attempting to solve them. But as long as the general property tax remains in effect, it must be administered as well as possible, and its administration calls upon tax assessors and courts to muddle through with some form of assessments. As this chapter is concerned primarily with the legal decisions, a few concluding comments on the doctrinal law are therefore in order. These comments may be prefaced with the statement that, considering the difficulties inherent in the whole system of real-estate taxation, the courts have done their share of the job remarkably and abstemiously well.

1. The law should abandon in words, as it has generally abandoned in fact, the dogma that market value constitutes the proper basis of tax assessment. Unless market value is interpreted to mean literally the price at which the present owner could actually sell his property to someone else, it is a meaningless and delusive term. But only the Wisconsin courts have had the courage to interpret market value in this literal sense, and in their case discretion would have been the better part of valor. Other courts have invoked the fiction of a "fair market value" as fixed by a hypothetical willing buyer and willing seller. But this is mere subterfuge. The opinion in the *New York Stock Exchange* case, frankly recognizing that the market-value standard is inapplicable to unique types of property, is far preferable.

2. If the general property tax is interpreted as an "ability" or "faculty" tax, value to the owner is a better standard of assessment

than market value where there is a wide and measurable discrepancy between the two values. But even value to the owner is unacceptable for real estate that has no significant value save as a part of a unitary business. Here, the taxation of real estate, as such, is indefensible under the ability principle. On the other hand, if this tax is designed fairly to allocate to property owners the costs of government made necessary by the construction and operation of their properties, undepreciated replacement cost has a shade the better of the argument as a proper tax base.

3. But whatever may be said for the replacement-cost standard of assessment in its own right, and not merely as a "measure" of value, its frank adoption would do such violence both to popular tradition and to legal doctrine, that there is no hope of securing its acceptance. That being the case, the courts are well advised in pursuing their past policy of accepting replacement-cost assessments unless the taxpayer can bring convincing evidence that his property is worth an amount measurably less than replacement cost.

4. The contention of taxpayers that their property should not be assessed in excess of the low market prices prevailing during the business depression is unacceptable for practical reasons. It could be sustained, if at all, only on condition that the present statutory and constitutional limits on governmental debts and on the rates of taxation be repealed.[132] Unless these limits are removed, assessors and courts will be forced, willy-nilly, to pretend that real estate is now worth more than it really is worth.[133]

[132] But see In re Lehigh & Wilkes-Barre Coal Co.'s Assessment, 298 Pa. 294 at 304, 148 Atl. 301 at 304 (1929), in which the court recommended a reduction in government expenditures as the solution of similar difficulties.

[133] Since this chapter was written, efforts have been made by taxpayers to secure relief from burdensome assessments by the adoption of methods of valuation whereby the "value" of the property would be measured by a capitalization of the annual income derivable therefrom. A bill making mandatory such a basis of valuation was introduced into the New York Senate early in the year 1936. See *New York Times*, Feb. 2, 1936, article by Godfrey N. Nelson on "Income Basis Asked in Valuing Realty." In its 1935 annual report, the New York State Tax Commission, commenting on the dissatisfaction with prevailing methods of assessment, called for "a more adequate system, reflecting *potential income*."

In the author's opinion, the use of capitalized income as the primary basis of real-property tax assessment is of doubtful merit: first, because it would meet the serious difficulty of distinguishing between "potential income" and currently realized income; second, because it falsely assumes that a real-estate tax is properly construed as an "ability" or "faculty" tax.

CHAPTER XVIII

VALUATION OF PUBLIC UTILITIES AND OTHER ENTERPRISES FOR TAX PURPOSES*

I. INTRODUCTION

An outstanding characteristic of the so-called general property tax, as reviewed in the previous chapter, is its conception of property in terms of physical objects of wealth rather than in terms of income expectancies. This characteristic gives rise to many difficulties of assessment; for a tax *in rem*, on tangible objects, fails to align itself with either of the two most significant units of wealth in a modern industrial society—with the total wealth of an individual on the one hand or of a business enterprise on the other hand. It therefore imposes on the assessor the necessity of valuing a mere part of an organic whole—of valuing a factory or a grocery store as distinct from a manufacturing business or a grocery business. And it leaves untouched those property values, suggested by the terms "good will" and "franchise value," that are not included in the appraisal of the physical assets.

The difficulty of distinguishing between the value of a parcel of real property and the value of the entire business located on the premises has proved serious even in the assessment of ordinary forms of real estate. But it becomes critical with respect to those unique combinations of land and structures used by railroads, other public utilities, and large manufacturing companies. In the first place, properties of this nature are physically and functionally integrated over wide areas, extending beyond the jurisdiction of a local assessor or even of a state board. In the second place, the physical plants of many public utilities and of some industrial companies have no value, over and above their salvage value, except as integral parts of the very enterprise by which they are now being exploited. In effect they are worth no more and no less than the business is worth, just as a man's heart or liver is worth no more and no less than the man himself is worth. Their replacement cost, despite some judicial dicta to the contrary, often fails to set even the upper limit of their value; for the replacement cost of the assets of a business limits their value only when

* Based on studies by Benjamin Goldring and C. S. S. Epstein.

these assets, were they to be destroyed, could actually be replaced without fatal interruption of the business.[1] If a large railway enterprise, such as the New York Central, were to be deprived of its right of way, retaining only its rolling stock, buildings, and franchise, it could not possibly replace this essential part of its plant in time to save its business; the whole enterprise would be ruined.

These difficulties and limitations of the general property tax, as applied to corporations in general and to public utilities in particular, were long ago recognized by the legislatures. As a result, special taxes were devised, designed to reach the values of corporate enterprises distinguished from the values of locally assessed parcels of improved or unimproved land. Some of these taxes, like the Federal capital-stock tax and the state "capital-stock" or "corporate-excess" taxes, have been imposed on corporations generally, with certain specified exceptions. Others, like the New Jersey railroad and canal property tax and the New York special franchise tax, have been confined to particular types of public utilities. All of them have two features in common: (*a*) the substitution of centralized state or Federal appraisal for local appraisal, and (*b*) the complete or partial recognition of enterprise values, including good will and franchise value, as a subject of taxation.

Needless to say, these newer forms of ad valorem taxation have given rise to much litigation both as to the precise nature of the property subject to assessment and as to the proper methods of valuation. A separate chapter on the valuation problems thus raised is therefore required. But the preparation of this chapter has been more difficult and more unsatisfactory than has any other part of our treatise, for reasons now to be noted.

In view of the impossibility of distinguishing between the value of an entire corporate enterprise, viewed as a profit-making machine, and the value of the unmarketable tangible assets of the enterprise, one might suppose that the legislatures would have abandoned the attempt completely and, breaking from the traditions of the general property tax, would have required an appraisal of the enterprise as a unit. With interstate businesses, to be sure, each state would then be compelled to use some allocation formula whereby it would tax only its fair share of this unitary, going-concern value. But except, perhaps, as a factor in the allocation formula, there would be no appraisal of the corporate *real* property and no need to distinguish between the values of tangibles and the values of intangibles. In this event, taxation would conceive of "property" entirely in terms of going concerns

[1] See *supra* pp. 71–76, 157–159.

rather than in terms of physical wealth, and it would conceive of "value" entirely in terms of income expectancies rather than in terms of "physical values."

Precisely this change in the concepts of property and of value has taken place under several of the modern corporation and public-utility taxes. It is exemplified by the Federal capital-stock tax, under which the value of the "capital stock" is interpreted, in effect, to mean the net value of the whole company. It is also exemplified by some of the state capital-stock taxes as well as by the ad valorem railroad tax statutes as administered in those few states which resort to an outright "unit-rule" method of assessment.[2]

But these are the exceptions, not the rule. Far more frequently, the legislatures have resorted to patchwork tax systems, retaining (sometimes with modifications) the principles of the general property tax in the assessment of corporate *tangible* properties, but superimposing other taxes, such as a corporate-excess tax, designed to reach the excess values or excess incomes of the going concerns. Seldom does the combination of these various taxes impose upon any one corporation substantially the same total tax burden that would be imposed by a single assessment of the value of the whole business. Sometimes the taxes overlap, sometimes they leave a hiatus; sometimes the aggregate of assessments is very much lower than would result from a unitary valuation, sometimes it is higher. With insolvent enterprises, the total assessment of the real property alone is likely to exceed the total value of the business.

This chaotic nature of the state corporation and public-utility taxes has inevitably resulted in a chaos of legal decisions and dicta as to the proper methods of valuation. Generalizations as to the legal rules of valuation are dangerous, since they must ignore the innumerable differences in taxing statutes, administrative procedures, and

[2] The current literature on railroad taxation greatly exaggerates the extent to which the "unit-rule" method of assessment has been adopted. To be sure, such states as New Jersey have applied this method in arriving at their share of the value of the "franchise" or "corporate excess"; and many states have applied it in the assessment of rolling stock engaged in interstate traffic. But only a few of them have applied it to the railroad enterprise as a whole—indeed, probably none of them completely so. Illinois, under its recently reorganized tax administration, comes closer to the full adoption of the rule than any of the examples studied for this chapter. See Sec. IV of this chapter. Truman C. Bigham reports that, of the southeastern states, "North Carolina alone from the first employed what has come to be called the true *ad valorem* test; *i.e.*, centralized unit assessment of railroads as going concerns." "Taxation of Railroads in the Southeast," 11 *Jour. Land and P.U. Econ.* 57 and 165, at p. 64 (1935). The various compendiums of tax statutes are quite unreliable on this point.

prior judicial decisions, that form the background of the rule of valuation accepted in any one case. To take a single example, consider the question whether or not an assessor will be upheld in assessing the *real property* of a railroad company at more than its estimated replacement cost, so long as this excess value can be defended on an earning-power basis or by a "stock-and-bond" valuation of the entire railroad company. This question has been answered in the negative by the New York Court of Appeals, in a case[3] which one is tempted to quote as holding that the real estate of a public utility, while it may be worth less than replacement cost, is never worth more. Yet the court defended its decision expressly on the ground that, in New York State, railroad values in excess of replacement cost were subject to other forms of taxation, including two types of franchise tax. Were it not concerned to prevent double taxation, the court might have declined to set replacement cost as the dead line of assessment of railroad real estate.

Little would be gained, therefore, by a résumé of dicta from various jurisdictions purporting to state general rules of public-utility valuation for tax purposes. Collected together without reference to their jurisdictional and factual environments, they would appear merely as a jumble of contradictions. A much more detailed scrutiny of the cases in their setting is required, such as one that might be made by separate studies of the assessment cases arising in each state and with respect to each type of enterprise.

But a comprehensive study of this minute character would require years of preparation and would fill a book quite as large as the present one. No writer to our knowledge has ever undertaken the task, which is quite beyond the scope of the present treatise. We must therefore be content with the sample method of presentation. After raising some theoretical problems, we first discuss the railroad-assessment cases arising in three states—New York, New Jersey, and Illinois—which present distinctive methods of public-utility valuation for tax purposes. Then we turn to the capital-stock and corporate-excess taxes, using the Illinois capital-stock tax, the Federal capital-stock tax, and the New York special-franchise tax as illustrations. Finally, we refer to Federal cases from other jurisdictions dealing with the proper methods of valuing an entire public-utility enterprise for tax purposes. One aspect of utility valuation for tax purposes is given only incidental attention in this chapter—the use of allocation formulas whereby a particular state assigns to itself some

[3] Delaware, Lackawanna & Western R.R. v. Clapp, 152 N.Y. 490, 46 N.E. 842 (1897), discussed *infra* p. 524.

share of the unitary value of an interstate enterprise. This subject is of such importance both to public finance and to value theory, that we reserve its discussion for the two following chapters, on the unit rule.

Value for Tax Purposes and Value for Rate-making Purposes.

Since most of the cases to be treated in this chapter are concerned with the taxation of railroad and other utility properties, it may be worth while to discuss here the economic merits of a controversy that is fundamental to the whole theory of utility assessment. The question is whether the "value of the property" that is set by statute and by constitutional law as the basis of taxation does mean and should mean the same thing as does the "fair value of the property" that has been prescribed by the courts as the basis of rate control.[4]

The reason why this problem is of such critical importance is that the interests of the public-utility companies are reversed with respect to valuations for these two different purposes. In rate cases, high values are claimed; in tax cases, low values. Both types of claim are often supported by highly paid expert witnesses, who reject or belittle in one case the very kinds of "evidence of value" that are deemed so persuasive in the other.[5] Often in a tax-assessment suit, counsel for the assessors will defend their appraisals by offering proof that they are lower than the values already established, or already sworn to by company representatives, as valid for rate-making purposes. Occasionally, though less frequently, tax assessments have been "considered" by public-service commissions as evidence of rate-making value.

One important distinction between a valid tax base and a valid rate base is so well recognized that it may be dismissed with a word. The rate base is supposed to correspond to the *full* value of the property "used and useful in the public service." But in taxation, the courts may reduce an assessment to an amount concededly less than "full" or "true" value, if the taxpayer can prove that property generally has been systematically underassessed in the same locality.

The truly controversial question, however, arises when the tax-paying utility insists that its assessment exceeds the full value of

[4] Sometimes the question concerns the acceptability, not of rate-making value *per se*, but rather of replacement cost as evidence of tax value in view of the fact that the courts have accepted this cost as the "dominant element" of value for rate-making purposes.

[5] For example, in the New Jersey Railroad Tax Cases, discussed *infra* pp. 543–547, railroad counsel and their witnesses, in advocating a valuation based on earnings rather than on structural costs, asserted that these costs are important in a rate case merely because "rate-making value" is not "true value."

the property and does not rely solely on the claim of *relative* overvaluation. Here, one might suppose, value of the property for rate-making purposes would be controlling. In this event, few public-utility assessments could be successfully challenged, since most of them are set well below rate-making values.

The pronouncements of the courts on this issue are conflicting;[6] nor are the conflicts explained by the differences in the tax systems under which the tax base is fixed. Some courts have said in effect that "value is value" and that the same "true value" must determine tax assessments, awards in condemnation, and valuations for rate-making purposes. Others have made distinctions, stating that tax assessments should be based on commercial value or market value, whereas "fair value" in a rate case is a figure determined largely by construction costs. Still others have hedged by declaring that the two types of value are closely related but that they are not necessarily exactly the same.

Most important, and most confusing, has been the position taken by the United States Supreme Court.[7] Speaking for a minority of his brethren, Justice Brandeis has said that "value is a word of many meanings" and that it is has a special sense when used as a test of confiscatory rates. But speaking for the Court, Justices Butler and Roberts have insisted that the "fair value" invoked in a rate case really means *value*—the same kind of value that serves as a standard under the laws of damages, condemnation, and taxation. Yet the types of "evidence of value" which the Court has accepted as testing the validity of a challenged tax assessment have been quite different from the types of evidence which it has held to be probative of fair value in a rate case. In the main, it has construed tax value in terms of the profitableness of the utility enterprise,[8] while it has construed rate-making value largely in terms of cost. The time will doubtless come when the Court will be compelled to choose between its formal doctrine in favor of a single concept of value, and its actual practice supporting dual or multiple concepts. So far it has simply ignored the contradiction.

For reasons to be discussed in the chapters on valuation for rate-making purposes, *economists* have been substantially unanimous in declaring that "fair value" as a basis of rate control cannot logically be construed to mean *value* in any accurate sense of the term. They

[6] In addition to the opinions in point cited in Sec. VIII of this chapter, see *supra* pp. 436–440; *infra* pp. 875–881, 1092–1108.

[7] See *infra* pp. 1092–1103.

[8] See the cases discussed in Sec. VIII of this chapter.

have also generally assumed that "value" as a tax base should really mean value—that is, should mean the commercial value of the property rather than its mere costliness. If both of these positions are valid, the oft-asserted distinction between tax value and rate-making value is also valid, and neither the companies on the one hand nor the assessors on the other hand may fairly be criticized for denying that the tax base should be set by the rate base, and vice versa.[9]

But it is at least open to argument that even "value for tax purposes" should be distinguished from commercial value and should be based on the same so-called "physical valuation" that is given dominant weight in rate cases. The force of this remark, which is admittedly heterodox fiscal doctrine, can be explained only by reference to the theory of utility taxation, on which something will be said presently.

Theory of Utility Taxation as Affecting the Principles of Assessment.[10]

In the chapter on the general property tax, the point was made that it is vain to discuss the proper methods of assessing real estate without reference to the basic question, Why should such property be taxed at a certain percentage of its *value?* We there gave a negative answer; an ad valorem real-property tax is, in our opinion, unwarranted.[11]

A similar problem presents itself in public-utility taxation. Why should railroad *A* be taxed twice as heavily as railroad *B* merely because it is *worth* twice as much? And why should a railroad company pay the same tax as does a gas company merely because the *values* of the two properties happen to coincide? Only after questions of this nature are answered have we any basic principle from which to deduce the conclusion that "value" should here be construed to mean replacement cost, or market value, or capitalized earnings, or any other thing that the term has been taken to mean.

But here, too, a negative answer seems to be indicated. That is to say, no authority in taxation has supplied a convincing defense of a public-utility tax measured by the value either of the physical prop-

[9] See for example, Harold M. Groves and George M. Keith, "Some Solved and Unsolved Problems of Public Utility Taxation in Wisconsin," 10 *Jour. Land and P.U. Econ.* 109 (1934), defending the Wisconsin practice of distinguishing between the rate base and the tax base.

[10] The economics of public-utility taxation is discussed by the current textbooks on public finance. See also the discussion by Herbert D. Simpson in Herbert B. Dorau, *Materials for the Study of Public Utility Economics* (New York, 1930), Chap. 9.

[11] *Supra* pp. 453–460.

erties or of the enterprise as a going concern. Certainly the "ability to pay doctrine" will not suffice. Many tax specialists, indeed, go so far as to reject this doctrine completely as applied to all corporate taxation. But with utility taxation, the case against it is utterly compelling in view of the fact that property taxes are deductible, like operating expenses, in the determination of the "reasonable rate of return" that is used as a basis of rate regulation. With this point in mind, some writers have urged with much force that utility companies should be exempt from every tax except an excess-profits tax designed to recapture the redundant earnings that are not precluded by prevailing methods of rate control.

The application of property taxes to utility companies is sometimes defended on another ground. It is argued that these companies should be taxed in the same manner, and at the same rates, as are other enterprises in order to prevent malapportionment of labor and capital devoted to the different industries. If the utilities, for example, were to be freed from taxation while remaining under rate regulation, their charges for service would become too low in relation to other prices—too low because they would stimulate a demand for service that could be supplied only by the employment of capital and labor more usefully employed in supplying clothing, housing, food, etc. This kind of economic distortion, it is assumed, can be prevented only by the application of a literally *general* property tax, or else by the complete abolition of a property tax in favor of some tax applied without discrimination to all forms of business including all public utilities. Here we have a sophisticated defense of the popular doctrine, embodied in many state taxing statutes and constitutions, in favor of "equal and uniform" taxation.

To an economist it is hardly necessary to point out serious flaws in this line of reasoning. What shall we say, for example, of the taxation of a railroad company on the value of its right of way despite the fact that the railroads' closest competitors, the motor vehicles, pay no tax measured by the value of the public roads? But one of the less frequently recognized fallacies in the "equal-and-uniform-tax" principle may be noted briefly—the assumption that the most desirable form of taxation is one which has no effect on price relationships. In fact, a strong case can be made for the exemption of certain utilities from taxation with the deliberate object of bringing utility rates more nearly down to the level of the *marginal* costs of service—to the costs of supplying additional units of service, without reference to overhead costs. The economic basis for this proposal is too complex for explanation here. But while it is still highly controversial among

economists, it has sufficient force to cast grave doubt on the significance of any defense of an ad valorem utility tax based on the principle of equality and uniformity.

One further argument in favor of a utility tax measured by property values remains to be noted. The point is made that a utility business, like any other business, should pay taxes sufficient to compensate the community for the outlays to which it is subject as a result of the construction and operation of the plant. The further point is made that these outlays vary roughly with the value of the plant that is being operated. A fifty-million-dollar electric-power plant calls for more governmental services than does a twenty-five-million-dollar plant, and calls for still more than does a ten-million-dollar plant. Hence, in default of more accurate measures of burdens imposed on government, utility properties should be taxed in proportion to their values, even though these taxes are passed on to the consumers in the charges made for service.

In the author's opinion, this "burden-of-government" argument constitutes the strongest case for the retention of utility property taxes. But its implications as to the proper methods of assessment require scrutiny. In the first place, any correlation that may exist between the relative *values* of utility properties and the relative burdens which their existence and operation impose on government must be so remote that a nicer measure of these burdens should certainly be sought for. The character of the property, far more than either its value or its cost, should be taken into account. For example, a hydroelectric plant may be four times as valuable and costly as is a steam plant of equal capacity; yet it may be less of a nuisance to the community because of its freedom from fire risk and smoke discharge. A railroad tunnel may be just as valuable and costly as is a railroad station; yet its operation may impose no material expense upon the community, whereas the operation of the station may impose a heavy cost. And what reasons have we for assuming that a fifty-million-dollar electric plant imposes upon the government approximately the same amount of outlay as does a fifty-million-dollar steam railroad? Ad valorem taxes, then, should be abandoned as soon as the science of public finance has developed nicer measures of the community burdens imposed by different types of physical properties and different types of business operations.

In the second place, it is probable that community burdens vary more closely in proportion to the amount of utility *real* property (or at least, of utility *tangible* property) than in proportion to the value of the utility enterprise as a profit-making organization. The operation

of a bankrupt railroad may impose quite as heavy costs upon the communities that it serves as does the operation of a profitable railroad of equal size. No doubt it was with this point in mind that an able committee of experts, in reviewing the New York tax system some years ago, recommended the abolition of all ad valorem taxes on utility companies, except local real-estate taxes.[12]

Finally, one may surmise that the mere *costliness* of a utility plant is a somewhat better criterion of the burden that it imposes on the community than is its (commercial) *value*. The bigness and formidableness of the plant, rather than its profitableness, are the important factors. This same point was made in the chapter on the general property tax, as furnishing a modicum of justification for real-estate assessments based frankly on undepreciated replacement cost. It is perhaps even more cogent as applied to public-utility properties, since the value of a utility plant cannot ordinarily be distinguished from the value of the utility enterprise.

If we are right in suggesting that utility property-tax assessments, as long as they are made at all, (*a*) should be confined to the real property or perhaps to all the tangibles, and (*b*) should be based on some measure of costs rather than on commercial value, it follows that the proper distinction between "value for rate-making purposes" and "value for tax purposes" is not so sharp as most economists have assumed it to be. Indeed, practical considerations suggest that the tax base and the rate base should be identified, even if theoretical considerations might warrant minor distinctions.

The points of view brought forward in this digression on the theory of utility taxation are highly unorthodox and do not explain the theories of valuation implicit in the case law reviewed in this chapter. But they are presented here in order to explain how difficult it is to pass upon the merits of alternative bases of tax valuation from the standpoint of fiscal or economic theory. The whole rationale of ad valorem taxation, as applied to corporations in general and to public utilities in particular, is so weak that the attempt to deduce therefrom a concept of "taxable value" is almost futile. To be sure, the professional appraiser is likely to assume that the proper method of assessment is that method which results in a valuation most nearly in accord with actual commercial value or "fair market value"—a

[12] State of New York, Report of the Special Joint Committee on Taxation and Retrenchment, submitted Mar. 1, 1922, p. 111. In addition to a real-estate tax, "narrowly defined," the committee recommended a public-utility tax on "pure economic profit," computed by the deduction from net earnings of a "fair return" on invested capital.

pardonable assumption, since it is supported by statute law and judicial opinions. But why commercial value itself is an acceptable tax base is a question that remains unanswered.

II. THE RAILROAD TAX CASES: NEW YORK RAILROAD REAL-ESTATE ASSESSMENTS

By far the richest case law on the valuation of public-utility properties for tax purposes is to be found in the field of railroad taxation. This is true partly because railroad history covers a whole century, partly because the railroads have contributed most heavily to the upkeep of government, and partly because the interstate character of the properties has so frequently raised Federal issues reviewed by the United States Supreme Court.

It is impossible, within the limits of this study, to canvass the vast number of railroad tax-valuation cases arising in all states. But since jurisdictional differences are vital, we have selected for special treatment the cases decided under the assessment procedure of three states—New York, New Jersey, and Illinois. Important Federal decisions in other jurisdictions are mentioned in Sec. VIII of this chapter; and one special aspect of railroad tax assessment, the use of allocation formulas under the unit rule, is treated at length in the two following chapters.

We begin with the railroad real-estate tax cases in New York,[13] since this state persists in subjecting the real property of railroads and of other public utilities to local assessment. But in studying these cases, one should bear in mind that New York has levied other important taxes on railroads, including (*a*) a general franchise tax on "capital stock" employed within the state, which varies with the rate of dividends, with the relation of assets to liabilities, and with the average market prices of outstanding shares! (*b*) an additional franchise tax of 0.5 per cent of intrastate gross earnings, (*c*) a "special franchise tax," centrally assessed, on the value of the right to use the highways and other public places as well as on the value of the structures located in these public places, and (*d*) until 1933, a local tax on personalty (from 1920 to 1933 only on tangible personalty) assessable only by the district in which the principal office is located. Interesting valuation problems have arisen under the special franchise tax, which is discussed in Sec. VII of this chapter in its application to all types of utilities.

[13] See Merlin H. Hunter, *The Development of Corporation Taxation in the State of New York* (Urbana, Ill., 1917), Chap. 7; State of New York, Report of the Special Joint Committee on Taxation and Retrenchment, Submitted Mar. 1, 1922, pp. 92–120.

Cases Prior to 1897.

The question how the assessors of a local district should value their segment of a railroad line was raised in court almost at the beginning of railroad history. In 1834, Chancellor Walsworth, in *Mohawk & Hudson R.R. v. Clute,*[14] suggested that this value might be ascertained by a comparison between the original construction cost of the property in question with the value of the company's capital stock. This suggestion would seem to imply that the railroad system as a whole should first be valued by reference to the market prices of its outstanding securities, and that the locality should assess such part of this unitary value as is represented by the ratio of the cost of the local property to the cost of the entire property.

Had Chancellor Walsworth's proposal been followed, it would have led to some form of unit-rule assessment, whereby the basic value for tax purposes becomes the commercial value of the railroad *enterprise* as a money-making unit, and whereby the local property becomes of no significance except as a factor in the allocation formula. But the New York statute law was not amenable to this development, since it singled out real estate for separate taxation by local assessment.

Two cases decided in the 1850's took a very different turn: *Albany & Schenectady R.R. v. Osborn,*[15] and *Albany & West Stockbridge R.R. v. Town of Canaan.*[16] In the former case, the assessors, apparently following the idea suggested by Chancellor Walsworth, had valued a short section of the railroad line by considering the "lucrativeness and income" of the entire railroad and by applying a mileage allocation to the section within their jurisdiction This procedure was sharply criticized by the court, and the assessment was reduced from $250,000 to $60,000, which the assessors had conceded to represent the "actual value" of the real property within the town "detached from the remainder of the road." Noting that the pertinent statute required that corporate realty be assessed "in the same manner" as was individually held realty, the court insisted that the property be appraised "irrespective of the consideration whether the road is well or ill managed, or whether it is profitable to the stockholders, or otherwise." Were this not done, the tax would really be converted from a property tax into an income tax, or at least into a tax on skill and thrift. A similar position was taken in the *West Stockbridge* case. Although, for technical reasons, the assessment was not disturbed, the court confessed its inability to see why two railroad lines, otherwise

[14] 4 Paige 384 at 395 (1834).

[15] 12 Barb. 223 (Sup. Ct. Albany Gen. Tr., 1851).

[16] 16 Barb. 244 (Sup. Ct. Albany Sp. Tr., 1853).

alike, should be taxed at different amounts simply because the one was prosperous while the other was not.

A reversion to the view that the value of a railroad right of way depends on the corporate earning power is revealed in *People ex rel. Buffalo & State Line R.R. v. Fredericks*,[17] decided in the 1860's. Although the company was prosperous, its stock selling at from $180 to $190 per share, it challenged an assessment at about 25 per cent below what, on a prior occasion, it had asserted to be the original cost of the property in question. Citing the previous opinions implying that segments of railroad lines should be valued as isolated pieces of property, it contended that its right of way should be valued at farm-land value and that its structures should be valued merely at the cost of the ingredient materials (omitting materials used in cattle guards, culverts, and bridges), with no allowance for labor costs of construction. In upholding the assessment, the General Term and the Court of Appeals agreed that the property should be valued "as part of" an entire railroad and not as an unrelated aggregate of land and materials. The lower court said that both cost and earnings should be considered, and the upper court said that each piece of property should be appraised by reference to its position and to the business and profit to be derived therefrom.

A line of cases decided in the 1880's still further emphasized earning power as the basis of assessment. Most of these cases were brought into court by allegedly unprosperous roads, which challenged assessments supposedly based on costs. In three of these cases[18] the courts reduced the assessments to figures deemed to be in line with capitalized

[17] 48 Barb. 173 (Sup. Ct. Erie Gen. Tr., 1866), *aff'd*, Same v. Barker, 48 N.Y. 70, especially at 77 (1871).

[18] People ex rel. Ogdensburgh & Lake Champlain R.R. v. Pond, 13 Abb. N.C. 1 (Sup. Ct. Gen. Tr. 3d Dept., 1882), *appeal dismissed*, 92 N.Y. 643 (1883). People ex rel. Rome, Watertown & Ogdensburgh R.R. v. Hicks, 40 Hun. 598 (Sup. Ct. Gen. Tr. 5th Dept., 1886), *aff'd*, 105 N.Y. 198, 11 N.E. 653 (1887). People ex rel. Fitchburgh R.R. v. Assessor, 2 N.Y. Supp. 240 (Sup. Ct. Albany Sp. Tr., 1888), *aff'd*, 3 N.Y. Supp. 86 (Sup. Ct. Gen. Tr. 3d Dept., 1888). See also Albany & Greenbush Bridge Co. v. Weaver, 67 How. Pr. 477 (Sup. Ct. Albany Sp. Tr., 1884), *aff'd*, 34 Hun 321 (Sup. Ct. Gen. Tr. 3d Dept., 1884). In the first two of these cases the opinions present elaborate formulas for the allocation of capitalized earnings to the locally assessed real properties. In the determination of income to be capitalized, interest on mortgage indebtedness was held non-deductible: Fitchburgh case, *supra*. Taxes were held to be deductible: Fitchburgh case. See also People ex rel. Boston, Hoosac Tunnel & Western R.R. v. Wilder, 3 N.Y. State Rep. 159 (Sup. Ct. Albany Sp. Tr., 1886); People ex rel. Walkill Valley R.R. v. Keator, 67 How. Pr. 277 (Sup. Ct. Ulster Sp. Tr., 1884), *aff'd*, 36 Hun 592 (Sup. Ct. Gen. Tr. 3d Dept., 1885), *appeal dismissed*, 101 N.Y. 610, 3 N.E. 903 (1885).

net earnings allocated on a per mileage basis. In another case,[19] where the railroad had failed to earn even its operating expenses, the assessment was reduced from $21,000 per mile to $10,000. Judge Peckham (later Associate Justice of the United States Supreme Court) here implied that such a railroad should be assessed merely "as a farm property, and with the cost of the rails as old iron added." In addition, he stated that "the possibilities of the future must be left to take care of themselves." In two other cases decided during this period,[20] the prorated-capitalized-earnings method was adduced by the court as justifying the challenged assessments.

The Lackawanna Case (1897).

The reversion of the above-cited cases to the capitalized-earnings method of local, real-property assessments was bound to raise hopeless difficulties—difficulties arising from the necessity of securing allocation formulas for distinguishing not only between real-estate value and other values, but also between values within and values without the locality. These difficulties were finally recognized by the Court of Appeals in *Delaware, Lackawanna & Western R.R. v. Clapp*,[21] which remains the "leading case" on New York railroad real-property assessments.

The case involved the reverse of the situation prevailing in the 1880's. Here the railroad was so prosperous that, as a business enterprise, it was worth much more than the cost of replacing its real property—probably more than the cost of replacing all of its physical assets. Recalling, no doubt, the previous decisions in which the courts had reduced the assessments of unprosperous roads to amounts less than replacement cost, the assessors had valued a 7-mile length of main line at *more* than cost, by "considering" costs, rentals, and earnings. In upsetting the assessment, which had been sustained in the lower courts, the Court of Appeals held that replacement cost should set the upper limit of assessments of railroad real property.[22] To be sure, it

[19] People ex rel. Boston, Hoosac Tunnel & Western R.R. v. Wilder, *supra* note 18.

[20] People ex rel. Walkill Valley R.R. v. Keator, *supra* note 18; People ex rel. Delaware, Lackawanna & Western R.R. v. Reid, 64 Hun 553, 19 N.Y. Supp. 528 (Sup. Ct. Gen. Tr. 5th Dept., 1892).

[21] 152 N.Y. 490, 46 N.E. 842 (1897).

[22] This holding is inconsistent with a dictum in People ex rel. Western Union Telegraph Co. v. Dolan, 126 N.Y. 166, 27 N.E. 268 (1891). There, too, the court rejected an assessment in excess of replacement cost. But the assessment in question was merely on structures (telegraph line) located on the public highway. This fact led the court to distinguish its decision from earlier cases holding that *railroad* properties might be assessed by reference to earning power. Railroads own the land on which their superstructures are built. But "land cannot be

noted, the assessors of other states had been upheld in basing their appraisals on a prorated share of capitalized earnings or of "stock-and-bond" value. But in these cases the taxing statutes covered *all* the railroad property, real and personal, located in the state, whereas under the New York statutes the tax in question was confined to local real estate, while other taxes were designed to reach the tangible and intangible personalty. It would therefore involve double taxation to allow local assessors to attribute to the rights of way in their communities a mileage share of the value of the railroad enterprise.[23] Replacement cost sets a reasonable and workable upper limit to the assessment of this type of property.

The court conceded that, while railroad realty might not be assessed at *more* than replacement cost, it must sometimes be assessed at a much lower figure, where the entire enterprise has a deficient earning power. Yet it implied that this cost (presumably with allowance for depreciation, although this point was not clearly made) is the *normal* basis of valuation, to be accepted in the taxation of "paying railroads." Its dicta on this phase of the problem leave many questions unanswered—questions that have become critical in recent years, when even the strongest railroad companies have failed to earn returns commensurate with their reconstruction costs.

Under the New York railroad tax system, which requires assessors to make absurd distinctions between the values of local segments of railroad lines and the value of a railroad system as a going concern, the Court of Appeals may have been well advised to set the replacement costs of these segments as the upper limit of assessment. But its

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reproduced"; hence, a valuation of railroad properties by a capitalized-earnings method was deemed justified. On the other hand, telegraph poles, wire, etc., are "articles which are manufactured, and which can be duplicated and supplied to any required extent at a certain known cost of production."

[23] This attitude, in reverse application, is foreshadowed by a prior case: People ex rel. Panama R.R. v. Commissioners of Taxes of City of New York, 104 N.Y. 240, 10 N.E. 437 (1887), which involved the taxation of the "capital stock" of a New York corporation which had an exclusive franchise to operate a railroad in Panama. Here the value of the real properties was deductible from the value of the enterprise, only the differential figure representing the value of the "capital stock." The tax commissioners had deducted $9,000,000, the amount paid for the construction of the road. But the taxpayer insisted upon a deduction of $15,000,000, arrived at by a capitalization of the road's net earnings minus the separately appraised values of its rolling stock and other personalty. In other words, the railroad contended that its real property alone was worth more than its cost. The court upheld the assessment on the ground that the taxpayer's claimed deductions included not only the value of its real property but also the value of its franchise, which was not deductible.

position is defensible only on the ground that an *arbitrary* line must somehow be drawn between property values to be reached by the real-estate tax and property values subject to other types of taxation. In Chap. IX we noted that the replacement cost of tangible property sets its maximum value only if the property, were it to be destroyed, could actually be replaced without serious delay and hence without the imposition of heavy "consequential damages" upon the owner.[24] This condition, however, does not prevail with respect to a vital portion of the right of way of an operating railroad. Such a property may well be worth far more than replacement cost, even if this cost be computed with full allowance for the excess prices that the railroad would have to pay in securing substitute rights of way by purchase or condemnation. Here we have an illustration of the point, which the Court of Appeals seems implicitly to have recognized without quite saying so, that "value for tax purposes" must often be interpreted to mean something quite different from "true value" in any generally accepted sense of the term.

Later New York Cases.

The rule in the *Lackawanna* case setting replacement cost as the maximum basis of real-property assessment has never been challenged and remains the law of New York. But two questions remained unsettled, and these have been treated, although quite inadequately, in later cases. The first question concerns the method of ascertaining depreciated replacement cost—a highly controversial problem. The second question concerns the circumstances under which an assessment at *less* than this cost will be required, together with the technique of setting the amount of the abatement.

People ex rel. New York, Ontario & Western Ry. v. Shaw[25] involved the methods of estimating replacement cost. The challenged assessment of a segment of the company's real property had been upheld by the lower court as not in excess of reproduction cost, abated in order to equalize the assessment with the prevailing underassessment of other properties in the locality. But the Appellate Division upset the assessment and was affirmed without opinion by the Court of Appeals. Since it declared that the railroad was not a "paying road" in the sense in which the term was used in the *Lackawanna* case, the Appellate

[24] *Supra* pp. 157–159.

[25] 143 App. Div. 811, 128 N.Y. Supp. 177 (3d Dept., 1911), *aff'd without opinion*, 202 N.Y. 556, 95 N.E. 1129 (1911). See also People ex rel. N.Y. Central & Hudson River R.R. v. Hanking, 152 App. Div. 488, 137 N.Y. Supp. 365 (2d Dept., 1912) (contention that replacement cost of tunnel and of grading should be excluded rejected).

Division *might* have denied that the assessment should be based on replacement cost, however measured. Instead, it chose to prune down the estimate of this cost. The pruning was done largely by a reduction in the valuation of the land. The court below had defended a land valuation of $15,000, "which was conceded to be three times the actual value of the land itself," on the theory that a railroad, in condemning or purchasing a right of way, would have to pay much more than market price by way of compensation and of incidental expenses. This valuation was reduced to $5,000 on the ground that the additional allowance was "speculative," and on the ground that farmers would probably be willing to sell strips of land to the railroad company at a low price, or even to donate the land, in order to secure transportation service. The Appellate Division also approved the rejection by the court below of any allowance for interest during construction, as being "speculative in amount and unsupported by evidence." One may note that the disallowance of the extra claim for land values accords with the subsequent holding of the United States Supreme Court in the *Minnesota Rate Cases.*[26] On the other hand, interest during construction is regularly allowed in rate-making valuations.[27] Indeed, it was later allowed in a New York railroad tax case when deemed to be supported by adequate evidence.[28]

The proper deduction for depreciation, which was not discussed in the *Shaw* case, was at issue in *People ex rel. Lake Shore & Michigan Southern Ry. v. Fizell.*[29] On the supposed authority of the *Lackawanna* opinion, which referred to the cost of reproducing the structure "in its existing condition," it was here held that replacement cost, as a measure of the upper limit of assessment, means by implication that cost minus depreciation. The court then cited *People ex rel. Manhattan Ry. v. Woodbury*[30] as holding that this depreciation must be computed,

[26] 230 U.S. 352 (1913), discussed *infra* p. 1141. Compare People ex rel. N.Y. Central & Hudson River R.R. v. Hilts, 27 Misc. 290, 58 N.Y. Supp. 434 (Onondega Sp. Tr., 1899), *aff'd without opinion,* 47 App. Div. 629 (3d Dept., 1900), *aff'd without opinion,* 163 N.Y. 594, 57 N.E. 1122 (1900) (tax case). But *cf.* People ex rel. Manhattan Ry. Co. v. Barker, 165 N.Y. 305, 59 N.E. 137 (1900) (capital-stock tax); and People ex rel. Manhattan Ry. v. Woodbury, 203 N.Y. 231, 96 N.E. 420 (1911) (special-franchise tax), discussed *infra* p. 603. For a New Jersey railroad-tax case on the same issue, see Central R.R. Co. v. State Board, 49 N.J.L. 1, 7 Atl. 306 (Sup. Ct., 1886), discussed *infra* pp. 539–540.

[27] See Whitten and Wilcox, *Valuation of Public Service Corporations* (Rev. ed., New York, 1928), Vol. II, pp. 1066–1082.

[28] People ex rel. Lake Shore & Mich. South. Ry. v. Fizell, 166 N.Y. Supp. 553 at 560 (Sup. Ct. Sp. Tr. Chautauqua Co., 1917).

[29] *Ibid.*

[30] 203 N.Y. 231, 96 N.E. 420 (1911). See *infra* p. 603.

for tax purposes, "by dividing the values of the various kinds of tangible properties by the number of years of their respective estimated physical lives"—in short, by the "straight-line" method. In the present case, to be sure, the referee had criticized the straight-line method as applied to a well-maintained railroad property, and his own report sustaining the assessment had used less drastic depreciation deductions. In view of the *Woodbury* case, the court thought that his position on this point might be in error. But it nevertheless upheld the assessment on the ground that, even if depreciation had been calculated on a straight-line basis, the resulting valuation would not indicate an excessive assessment.[31] The dictum in this case in favor of straight-line depreciation is in conflict with recent opinions of the United States Supreme Court belittling the use of this method in rate-making valuations.[32] Indeed, the *Woodbury* case itself was not a precedent for the position suggested in the *Fizell* case, since it referred to the very different problem of the depreciation allowance as an annual deduction from gross earnings in the ascertainment of the net earnings that should be capitalized as a basis for measuring the value of a "special franchise."

By all means the most important question unsettled by the *Lackawanna* case concerns the right of a railroad to demand an assessment at *less* than replacement cost (minus conventional deductions for depreciation) on the ground of deficient earning power. This issue was raised in two important cases that are difficult to reconcile.

The first of these cases, *People ex rel. Mid-Crosstown Ry. v. State Tax Commission*,[33] involved the assessment of street-railway properties under the special franchise tax. But this tax, despite its misleading name, includes a tax on the appraised values of utility structures located in public streets, in addition to a tax on intangible values. Judge Lehman therefore treated the assessment of the railway tracks and structures as involving the same principles that are applied under the ordinary real-property tax. The State Tax Commission had here assessed the structures at estimated reproduction cost minus a 25 per cent allowance for depreciation. The company claimed a 50 per cent deduction on the ground that no higher valuation could possibly be justified in the light of its earning power. This claim was

[31] The court also said (166 N.Y. Supp. 553 at 559): "The allowances made by the learned referee prove, on inspection of the testimony, to be based on the actual condition of such structures and material. The assumption that a railroad rail will depreciate to a certain percentage after a given number of years' wear cannot prevail over testimony as to its actual condition."

[32] *Infra* pp. 1131–1133.

[33] 192 N.Y. Supp. 388 (Sup. Ct. Sp. Tr. N.Y. Co., 1921).

supported by a showing that the company had suffered serious operating deficits for the past 4 years. But even this persuasive evidence of low commercial value did not induce Judge Lehman to upset the assessment. We quote from his opinion:[34]

> In the present case the relators show that for a considerable period of time the railways have been earning no profits and perhaps not even operating expenses, but, in my opinion, this evidence alone is not sufficient to rebut the presumption that the assessments are correct. The railways are still being operated for profit, and it is therefore fair to assume that the directors feel that there is a reasonable chance that the structures will earn some return in the future or can be sold as a going concern. In the absence of evidence which would enable the court to say that the failure to earn any return is due to conditions beyond the control of the companies, which are of such permanence that the structures cannot as a matter of law and for any possible use or purpose be worth 75 per cent of the cost of reproduction, I cannot find that the relator has established that these assessments are erroneous.

The implication of this opinion is that assessors will be upheld in basing their assessment on replacement cost minus standardized or traditional allowances for depreciation, unless the taxpayer can furnish decisive proof that it is *incapable* of earning a reasonable return on this figure.

People ex rel. New York Central R.R. v. Thompson,[35] the most recent case in point, indicates a much more friendly attitude toward a claim for an abatement of the assessment because of deficient earning power. Here the taxpayer had challenged the local assessment, for the year 1931, of the section of its real property located in Ontario, N.Y., on the "Ontario Division." It offered proof that, during the past several years, the earnings of the entire company had declined, so that in 1930 and 1931 they amounted to far less than a reasonable return on its "total investment"; and that its Ontario Division was being run at a positive loss, as was its local business in the particular taxing jurisdiction. This situation led the referee to recommend a greatly reduced assessment. His report was confirmed and published in lieu of a judicial opinion.

This report indicates that the assessors had themselves valued the properties at 16 per cent below their own estimate of depreciated replacement cost, which they had secured from an appraisal expert. The referee himself estimated depreciated replacement cost at a much lower figure; and from this reduced estimate he deducted 25 per cent as an allowance for deficient earning power.

[34] 192 N.Y. Supp. at 393.

[35] 156 Misc. 536, 282 N.Y. Supp. 269 (Sup. Ct. Wayne Co., 1935).

With a road that is "not a paying property," declared the referee, the assessors should "consider" earnings, and not merely replacement costs. How these earnings should be taken into account is admittedly a difficult question calling for the exercise of "judgment." One of the difficulties of the problem is that of defining "value" for the purpose at hand. The market-value criterion, he indicated, is clearly inapplicable to a local portion of a railroad. Even "commercial value" (which he did not define) is not the invariable standard. "It is the value for taxation that controls, and not the value for some other purpose." By what criteria he discovered that the "value for taxation" of the particular property was 25 per cent less than his estimate of depreciated replacement cost is an undivulged secret. But he furnishes a clue by suggesting that, since the earning power of the railroad had recently declined, therefore the assessment should be reduced instead of being increased as it was. This idea that, when earning power goes down, assessments should be lowered, is also suggested in a recent opinion of the United States Supreme Court,[36] discussed in a later section of this chapter.

Conclusions on the New York Railroad Realty-assessment Cases.

From the standpoint of appraisal theory it is easy to find loopholes in the reasoning of the New York opinions just reviewed. No one of them, for example, supplies any answer to the basic question, What is meant by the *value* of a tiny section of the right of way and structures of a railway system? No one of them (except, perhaps, the *Lackawanna* opinion with its emphasis on replacement cost) offers any consistent, workable method of finding this value, however the word be defined. Yet the trouble is not with the courts, which have handled the practical problems presented to them as well as any appraisal expert could do. It lies rather with a statutory system of taxation which makes the absurd assumption that the *value* of the particular segment of the real property of a railroad which is located within a given taxing jurisdiction is an acceptable measure of the amount of tax which the railroad should pay to the locality. The primary difficulty is not that this value cannot be ascertained. It is rather that, even if it could be ascertained with perfect accuracy, it would be utterly unacceptable as a tax base. An essential portion of an organic whole, such as a 5-mile length of the main line of the New York Central system, has not one value but two: its salvage value as so much land and scrap iron, and its value to the entire railway system. To tax the portion at its salvage value would be con-

[36] Great Northern Ry. v. Weeks, 297 U.S. 135 (1936), discussed *infra* p. 627.

cededly ridiculous. But equally ridiculous would be an attempt to tax the portion at its value to the whole system. For the sum of the values of the parts would then be much greater than the value of the whole.[37] Here, then, is a dilemma from which there is no escape if one take seriously the requirement of the tax statutes that each locality must assess its section of a railroad right of way at its "actual value." It is a dilemma from which the courts have escaped in part only because they have adopted arbitrary principles of assessment which have afforded a tolerable basis of taxation *by virtue of their very refusal to adhere to valid principles of commercial valuation.*

III. RAILROAD TAX ASSESSMENTS: NEW JERSEY[38]

Of all the state railroad tax systems, that of New Jersey gives most promise of shaping the future judicial law on valuation for tax purposes. Here an issue is being drawn, more impressively than in any other state, between the position that railroad properties may be taxed at their so-called "physical values"—at amounts based largely on those cost data that are dominant in valuations for rate-making purposes—and the position that "value for tax purposes" means commercial value and hence must be measured by the value of the railroad *business* as a source of income. So far, the New Jersey courts have upheld the state assessors in basing their valuations of tangible properties on costs, without direct reference to earning power. But appeals have recently been taken, and more will doubtless be taken, to the Federal courts; and the methods of valuation approved by the state courts will probably be challenged on the ground that they contravene the "due-process" and "equal-protection" clauses of the United States Constitution.

Many years ago, to be sure, a somewhat similar issue went to the Supreme Court on appeals by utility companies from tax assessments imposed upon them in a number of western and southern states.[39] There the assessors, acting under the provisions of the taxing statutes, had assessed the properties of prosperous companies at amounts far in

[37] This point is discussed *supra* pp. 76–82, and *infra* pp. 677–679.

[38] See M. C. Waltersdorf, "Taxation of Public Utilities in New Jersey," 20 *Nat. Tax Assn. Bull.* 8 (October, 1934); Winthrop M. Daniels, "Taxation of Railroad and Canal Property in New Jersey," 20 *Quar. Jour. Econ.* 617 (1906); Hsien-Ju Huang, *State Taxation of Railroads in the United States* (New York, 1928), pp. 35–41; The Commission to Investigate County and Municipal Taxation and Legislation, Report No. 6, *The Revenue System of New Jersey* (Trenton, 1931), pp. 36–44

[39] See *infra* pp. 614–615, 640–657.

excess of depreciated structural costs. These assessments were arrived at by the "unit-rule" method, whereby the enterprise of an interstate company is first valued as an organic whole, by reference to capitalized earnings or stock and bond quotations, and whereby some share of this unitary value is imputed to the properties lying within the given taxing jurisdiction. In a line of cases to be discussed in the following chapter, these assessments were upheld by the Supreme Court. It is therefore the settled law of the land that, under appropriate state legislation, assessors may value utility properties for tax purposes at amounts far in excess of the structural costs of the tangible properties, so long as this excess valuation is deemed to be warranted by excess earning power.

One might suppose that this well-established legal rule would work both ways, by deterring any state from assessing utility properties at amounts not deemed justified by the criterion of capitalized earnings or of stock and bond values, even though these amounts are well within the limits of replacement cost minus accepted allowances for depreciation. And so it has worked, on occasion. In *Chicago & North Western Ry. v. Eveland*,[40] the Federal Circuit Court of Appeals upset a South Dakota assessment closely approximating the amount which the railroad itself had claimed, before the Interstate Commerce Commission, as the value of its South Dakota properties. The court here said that the assessors had failed to give to earnings and to stock and bond prices "the decisive influence in determining the value of the property under consideration to which they were entitled." "Physical valuations" were denied much weight on the ground that they "were based on prices and costs—not on value for taxation or sale."

No doubt the precedent of the *Eveland* case will be pressed by the New Jersey railroads before the Supreme Court, if their tax appeals finally come before this court of last resort. But in defending its tax levies, New Jersey will be in a less vulnerable position than that of other states whose railroad assessments have been upset in the Federal courts. For in the assessment of tangible railroad properties, New Jersey has *always* resorted to physical valuations[41] and has never looked beyond its own borders to the capitalized earnings or stock and bond prices of an interstate carrier. For many years this procedure has gone unchallenged, and it has been sanctioned repeatedly

[40] 13 F. (2d) 442 (C.C.A. 8th, 1926), discussed, *infra* p. 620.

[41] See testimony of Louis Focht, chief engineer of the division of railroad valuation and taxes, to the effect that the same methods of assessment have been used since 1884. Summarized in 114 N.J.L. 69 at 73, 175 Atl. 637 at 639 (1934)

by the state courts. Counsel for the state will therefore have the support of "long-continued practice"—a factor of some persuasion where the question of "due process" is involved. Moreover, the briefs and arguments before the State Board of Tax Appeals and the state courts indicate that counsel for the state are alert to make the most of the many opinions in which the United States Supreme Court has denied that "value for rate-making purposes" is fundamentally different from value for other legal purposes—a denial which railroad counsel themselves have expressed with great force in valuation cases before the Interstate Commerce Commission.

The New Jersey Railroad Tax Statute.

Although amended several times, the statute governing the taxation of railroad properties remains basically in the form in which it was first enacted, in 1884.[42] All property owned by a railroad, save property for non-railroad use (which is locally assessed), is appraised by a state board. But the statute divides this property into four classes and requires a separate appraisal of each class:

Class I. "Main stem," comprising not only the main right of way and tracks within a 100-foot width, but also the superstructures and buildings thereon except passenger and freight stations.

Class II. Other real property, including side tracks and structures thereon, terminal yards, buildings off the main stem, and passenger[43] and freight stations even if on the main stem.

Class III. Tangible personalty, comprised largely of rolling stock.

Class IV. "The remaining property including the franchise."[44]

For the first, third, and fourth classes, a state-wide valuation suffices, since the entire tax (levied at the "average rate of taxation" used throughout the state) goes to the state. But on second-class property, separate appraisals for each local tax district are required,

[42] L. 1884, p. 142; revised, L. 1888, p. 269; at present, Compiled Statutes (1709–1910), Taxes and Assessments, Sec. 445 *et seq.* The statute also covers the taxation of canal properties, but in recent years only one small canal has been assessed thereunder.

[43] Passenger stations were at first put into Class I but were removed to Class II by the Laws of 1906, p. 220. Constitutionality of the change upheld, Central R.R. v. State Board of Assessors, 75 N.J.L. 771 at 780, 69 Atl. 239 at 243 (1908).

[44] The present phrasing was introduced in 1888 and superseded the earlier phrase referring merely to the "franchise." Apparently the legislature wished to make it clear that *any* intangible value, however designated, must be included. Compare the public-utility-rate cases distinguishing between "going value," "franchise value," and "good will"; *infra* pp. 1142–1151. But the change has had no clear effect on the New Jersey assessments, and Class IV property is still constantly referred to as covering simply "the franchise."

since the taxes thereon (levied at the local tax rates) go entirely to the districts.

With respect to all classes of property the statutory standard of assessment is the same—"true value," a phrase also used by the state constitution. Nothing is said as to the methods of valuation, although the statute requires the railroads to submit annual reports divulging certain information including the following: (*a*) location, description, and claimed value of all tangible properties, (*b*) authorized and paid-in capital, (*c*) market value, or if no market value, then "actual value," of outstanding shares of stock, and (*d*) amount and details of all indebtedness. No specific mention is made of original or replacement cost, or of gross or net earnings, although the assessors are authorized to call for any additional data.

Methods of Appraisal Used by the Assessors: Tangible Properties.

Broadly speaking, the assessments of the three classes of tangibles have been based on estimates of depreciated replacement cost, while the "other property including the franchise" has been valued by some measure of the excess in the value of the railroad as a going concern over the values assigned to the tangibles. Both of these statements, however, require qualifications by reference to such information as can be gleaned from the litigated cases and from official reports. It must be remembered that the assessors, following the practice in other states, have not clearly disclosed their detailed methods of appraisal, although their representatives have taken the witness stand in a number of recent tax appeals.[45]

As to the appraisal of the tangible properties, land was at first, at least, valued strictly on a replacement-cost theory. Land used for right of way was valued at two or three times the prevailing market price per acre of adjacent land, on the assumption that a railroad would be obliged to incur these extra costs in condemnation. This practice was upheld by a New Jersey court in an early case,[46] later to be mentioned.

In the year 1911, a special expert, Charles Hansel, made a *Report on Revaluation of Railroads and Canals, New Jersey,*[47] which was called

[45] See 114 N.J.L. 69 at 73, 175 Atl. 637 at 639 (1934).

[46] Central R.R. of New Jersey v. State Board of Assessors, 49 N.J.L. 1, 7 Atl. 306 (Sup. Ct., 1886).

[47] State Printers, Trenton, N.J., 1912. The report seems to have been called for because of a popular feeling that railroad properties had been underassessed. Mr. Hansel's proposed valuation of all of the New Jersey railroad properties was 374 million dollars as compared to the 1910 assessment of 286 million. His chief increases were in Class III valuations, although Class IV was boosted 50

for by an act of the legislature. This report recommended the valuation of railroad land at the mere current market value of adjacent land. Mr. Hansel thought that the use of multipliers or increments was in violation of a principle, previously announced by the state Supreme Court,[48] that the valuation of tangibles must not include any allowance for the special value of the property to the taxpayer himself; otherwise the assessment would include some element of franchise value. But the state board, while accepting most of the other recommendations of the Hansel report, did not agree on this point and persisted in its practice of valuing land for rights of way at more than the current market prices of adjacent properties.[49] Whether or not they have kept to this procedure in recent years is a question to which we have vainly sought a definite answer.

Class I structures, together with rolling stock, have been valued at estimated replacement cost, minus allowances for depreciation (including obsolescence) based on "judgment" rather than on definite formulas. We have no information as to the allocation of rolling-stock values of interstate railroads, although the Hansel report of 1911 made use of an all-track mileage formula.[50]

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per cent. Class I values were only slightly increased. After prolonged hearings, the state board expressed general agreement with the results of the Hansel report. Nevertheless, it increased its 1911 assessments only to 324 million dollars. 28th Ann. Rep. State Board of Assessors, 1911, Pt. I, p. 10. For a similar tax appraisal of railroads, see Michigan Railroad Appraisal 1901, by Mortimer E. Cooley and Henry C. Adams, apparently not published but filed in the office of the Michigan Board of State Tax Commissioners. See its first report, year ending Dec. 15, 1900, pp. 66–70, 176–182; and second report, 1901–1902, pp. 50–57. For railroad valuation on the capitalized-earnings plan, see U.S. Dept. of Commerce and Labor, Bureau of the Census, Bulletin 21, *Commercial Valuation of Railway Operating Property in the United States* (1904). See also Edward W. Bemis, *Report on the True Value of Ohio Railroads for the Purpose of Taxation* (Cleveland, undated).

[48] See Long Dock Co. v. State Board of Assessors, 78 N.J.L. 44 at 53, 73 Atl. 53 at 57 (Sup. Ct., 1909), *aff'd on opinion below*, 79 N.J.L. 604, 80 Atl. 1135 (E. & A., 1910). The holding in this case, as will be noted later, involved only terminal lands, but Mr. Hansel apparently deemed it applicable also to rights of way.

[49] 28th Ann. Rep. State Board of Assessors, 1911, Pt. I, p. 6. The board denied that the valuation of railroad land in excess of current market prices of adjacent land involved the inclusion of any allowance for franchise value. It added that, in any event, a high land valuation would be largely offset by a lower franchise valuation—a remark valid only when the entire railroad enterprise, valued as a unit, is found to be worth more than the values assigned to the tangible properties.

[50] The Hansel report defended the use of a mileage allocation merely in default of more satisfactory data. The state courts have held that rolling stock used entirely or principally in interstate commerce is not taxable by the state, at least not if the railroad company is a foreign corporation. Central R.R. of N.J. v.

The assessment of the locally taxed, Class II properties, especially the extremely valuable terminal properties on the Hudson River, has been the subject of much litigation. The Hansel report[51] seems to have accepted, as the basis of appraisal, the current market prices of adjacent land plus the depreciated cost of reproducing the structures.

From what has just been said, it is evident that the tangible properties have been valued for tax purposes by the same basic methods that are employed, with the approval of the state and Federal courts, in the valuation of public-utility properties for rate-making purposes. A so-called physical valuation, rather than an appraisal based on capitalized earnings or stock and bond prices, has been used consistently. The assessors, however, have kept their valuations well below the amounts that the railroads would be able to establish as a measure of their rate base.[52] Deductions for depreciation have been relatively generous, while structures that are deemed to be of a non-income-yielding character have been marked down drastically or even completely ignored in the inventory.[53] No doubt this fact, together with the fear of the railroads that a claim of lower physical values

State Board of Assessors, 49 N.J.L. 1 at 20, 7 Atl. 306 at 316 (Sup. Ct., 1886); West Shore R.R. v. State Board of Taxes and Assessments, 92 N.J.L. 332, 104 Atl. 335 (Sup. Ct., 1918). Compare the contrary position later taken by the United States Supreme Court: Pullman's Palace Car Co. v. Pennsylvania, 141 U.S. 18 (1891); American Refrigerator Transit Co. v. Hall, 174 U.S. 70 (1898). We are not informed whether or not the state board still follows the early New Jersey cases.

[51] At p. 65 *et seq.*

[52] Note the following comparison between the Interstate Commerce Commission's rate-making valuations for New Jersey, brought down to Dec. 31, 1932, by the addition of new investments, and the 1933 tax assessments for the same railroads.

Railroad	I.C.C. valuation	Assessment
Delaware, Lackawanna & Western	$157,578,281	$ 85,386,862
Central Railroad of New Jersey	156,191,365	102,351,077
Erie	87,062,592	50,136,198
Lehigh Valley	79,597,070	45,694,813
New York, Susquehanna & Western	16,890,166	9,147,081

The I.C.C. valuations are taken from a letter signed by M. M. Stallman, counse for the railroads in a recent litigation, dated Jan. 2, 1935, and addressed to D. E. Minard, counsel for the state board. The assessments are taken from 114 N.J.L. 69, 175 Atl. 637 (1934), and purport to represent "full value," without any "equalization" by reference to undervaluation of other properties in the state.

[53] Under L. 1931, C. 227, no assessments may be imposed on the costs of grade-crossing eliminations made under the provisions of certain statutes.

might prejudice their claims for high valuations in a rate case, explains the lack of those numerous controversies that so frequently attend a legal appraisal based on estimates of depreciated replacement cost.

Methods of Appraisal Used by the Assessors: Franchise.

The valuation of the "remaining property, including the franchise" (Class IV) has necessarily been based on entirely different methods from those applied to the tangibles. In earlier years, the assessors resorted to the "stock-and-bond" method of valuing the entire railroad as a going concern, deducting therefrom the total appraised values of the tangibles. For some unstated reason they took a mere fraction of this differential value (60 per cent in a case to be noted later) as measuring the "true value" of the franchise. With interstate railroads some allocation formula was used.

Although this method was upheld by the courts in cases to be discussed below, it seems to have been abandoned after 1911 as a result of the Hansel report. This report noted several objections to the "stock-and-bond" method of valuing the entire enterprise, the chief objection being that the stocks of most of the New Jersey railroads, which were mere subsidiaries of larger companies, had no established market values.[54] A capitalized-earnings method was therefore recommended. With respect to most of the railroads, Mr. Hansel's formula capitalized the excess net earnings (computed after the deduction of taxes on the tangibles) over and above a 5½ per cent return on the tangibles, at 6 per cent plus the prevailing average tax rate. The return on the tangibles was based on their *undepreciated* appraisals—an unusual procedure, the merits of which were not discussed in the report. Apparently Mr. Hansel found it convenient to use merely the earnings of a single year, although he indicated that a 5- to 10-year average would be preferable.

In estimating the net earnings of the New Jersey portion of an interstate railroad system, the Hansel report was obliged to use crude allocation methods in default of adequate data. But the state

[54] Other objections noted in the Hansel report were: (*a*) that the market values of outstanding securities reflect the income anticipated from *all* corporate assets (including investments in other companies), and not merely income from railroad operations; (*b*) that many of the securities of subsidiary railroads are guaranteed by strong parent companies and hence have a market value partly independent of the value of the issuing corporation.

As to the difficulty of valuing stocks and bonds without established market prices, the courts, in using the stock-and-bond method, have accepted par values of the shares and face values of the indebtedness in the absence of proof of a different market value. See the West Shore case and the New Jersey Junction Railroad case cited in notes 72 and 75, *infra*.

board, which accepted the formula in principle, declared that it would allocate to New Jersey a share of the net earnings based on the ratio of estimated *gross* earnings allocable to the state, to gross earnings of the entire railroad.[55]

No information is available as to the methods of assessing the franchise during the recent years of impaired railroad earnings. The reported assessments, however, indicate that material, though relatively small, values have been placed on franchises even during periods of average earnings well below the 5½ per cent line. In 1933, the aggregate valuation of franchises for the state was set at over $5,000,000, as against an aggregate valuation of all tangibles at $500,000,000.[56] In 1911, franchises were valued at $35,000,000 and tangibles at $289,000,000.[57] Since that date, the trend of franchise valuations has been more or less steadily downward.

From the standpoint of a state desiring the highest possible assessment, the charm of the above-outlined procedure is that it gives the state the opportunity of assessing an entire railroad by reference to structural costs when earnings are relatively low, and by reference to commercial value when earnings are relatively high. This is true because, when railroads are prosperous, the valuation of their franchise at a high figure becomes operative as an addition to the physical valuations of the tangibles; whereas, when railroads become unprofitable, the "physical values" remain standing, with whatever arbitrary abatements the assessors may decide to take off.

Litigated Assessments Prior to 1933.

Since its enactment in 1884, the statute in question is said to have given rise to more than 100 litigations in the New Jersey courts.[58] Only a handful of these cases, however, are of concern to the student of valuation. For our purposes we may ignore the issue of *relative* overassessment, frequently raised by the railroads, and consider only those cases in which the contention is made that the assessment in question has exceeded the "true value" of the properties.

In the first important case, *State Board of Assessors v. Central Railroad of New Jersey*,[59] the railroads challenged the constitutionality

[55] 28th Ann. Rep., 1911, Pt. I, p. 8. The board did not state how it determined the "fair amount" of gross earnings allocable to New Jersey, "taking into account the terminals."

[56] State Tax Dept., 2d Ann. Rep., 1933, Pt. II, p. 3.

[57] 28th Ann. Rep., 1911, Pt. I, p. 10.

[58] Statement by State Board of Tax Appeals, 57 *N.J.L. Jour.* 115 at 117 (1934).

[59] 48 N.J.L. 1, 2 Atl. 789 (Sup. Ct., 1886), *rev'd*, 48 N.J.L. 146, 4 Atl. 578 (E. & A., 1886).

of the whole statute, on the ground that its special provisions for the assessment and taxation of railroads, especially with its fourfold classification of properties, violated the requirement of the state constitution that "property shall be assessed for taxes under general laws and by uniform rules, according to its true value." The lower state court held the act unconstitutional, only to be reversed by the Court of Errors and Appeals. In the light of recent litigation, an argument by one of the railway counsel, B. Williamson,[60] is of special interest. Citing prior railroad tax decisions in other jurisdictions, he contended that the "true value" of a railroad property is dependent on earning power, but that an assessment on this basis was precluded by the fourfold classification of types of properties called for by the statute. Even the lower court, although declaring the act unconstitutional on other grounds, did not find this argument persuasive; for it assumed that the total assessment would be determined by the value of the railroad as a whole, this value then being "distributed into valued parts."[61] No such procedure, however, has been followed by the assessors, although the railroads have recently insisted that this is the intent of the statute.[62]

The methods of valuation used by the assessors were challenged in *Central Railroad Co. v. State Board*,[63] decided in 1886. The railroads objected that the board was disregarding the statutory standard, "true value," by using original cost of acquisition less an allowance for wear and tear, or else reproduction cost, as the absolute basis for its assessments of the tangibles. Conceding that "true value" is not the same thing as cost, the court refused to believe that a board so skilled in appraisal technique could have been guilty of "an error so utterly puerile." But the board was held to be quite justified in taking cost into consideration. Moreover, "such approximations between these respective valuations were to be expected, for no reason is perceived why the property of a successful railroad is not worth about the sum that it would cost to replace it, allowance being made for its depreciation from use."[64]

The same opinion considered a more specific objection, raised by the railroads, against the assessments of land for right of way. As noted in an earlier section, the assessors had valued the land at two or three times the current market price, per acre, of adjacent land, on the

[60] See 48 N.J.L. at 180 *et seq.*

[61] See 48 N.J.L. at 8; also *ibid.* at 278, 292, 300, 322, 338.

[62] Central R.R. of N.J. v. Martin, 114 N.J.L. 69 at 74, 175 Atl. 637 at 639 (Sup. Ct., 1934). The court denied that such was the intent of the statute.

[63] 49 N.J.L. 1, 7 Atl. 306 (Sup. Ct., 1886).

[64] *Ibid.* at p. 6.

ground that a railroad, in purchasing or condemning the land, would incur excess costs of this magnitude. The court upheld the assessment on the reproduction-cost theory. This case, be it noted, long antedated the holding of the United States Supreme Court in the *Minnesota Rate Cases*,[65] rejecting the use of "multipliers" in the valuation of rights of way for rate-making purposes. No later reported case involving the principles of right-of-way valuation has come to our attention; and we are not informed whether the assessors have continued to use multipliers or increments in their appraisal of this type of land.

Until 1933, most of the disputes as to the valuation of railroad tangibles were concerned with the taxes on Class II properties, which are centrally assessed but locally distributed—chiefly with the taxes on terminal land. Here the courts have said that "money exchange value" (*i.e.*, market value), as distinct from special value to the possessing railroad company, must govern the appraisal. But the opinions are not clear either as to the definition of exchange value for the purpose at hand, or as to the precise methods of valuation.

In *Long Dock Co. v. State Board of Assessors*,[66] the court found that certain terminal lands had been assessed in excess of market value, and that this excess represented "the value imparted to such land by its specific use under a railroad franchise." One may surmise that the state board had made use of multipliers in making its appraisals. In any event, the court upset the assessments on the ground that they exceeded market value and hence included an element of franchise value. Under the statute, it was held, the latter value is assessable only as Class IV property and is taxable for the exclusive benefit of the state.

But the court hedged its distinction between the permissible assessment at mere "market value," and the tabooed assessment which included "franchise value," by phrases reminiscent of those so often employed in distinguishing between "fair market value" and "value to the taker" under the law of eminent domain.[67] For it added:

> We are not intending to suggest that the availability of land for railroad purposes generally may not be shown and taken into account in the ascertainment of its market value. The difference, however, between the market value of land by reason of its availability for railroad purposes generally,

[65] 230 U.S. 352 at 445 *et seq.* (1913). See also People ex rel. N.Y., Ontario & Western R.R. v. Shaw, 143 App. Div. 811, 128 N.Y. Supp. 177 (Sup. Ct. 3d Dept., 1911), *aff'd*, 202 N.Y. 556, 95 N.E. 1137 (1911), discussed *supra* p. 526.

[66] 78 N.J.L. 44 at 53, 73 Atl. 53 at 57 (Sup. Ct., 1909), *aff'd on opinion below*, 79 N.J.L. 604, 80 Atl. 1135 (E. & A., 1910). See 27th Ann. Rep. State Board of Assessors, 1910, Pt. I, p. 7.

[67] *Supra* pp. 422–426.

and the value imparted to such land by its specific use under a railroad franchise, is so great as to be fundamental. The latter value is special and peculiar to the individual user of the land proceeding as it were from within, whereas the former is general and is based upon external conditions susceptible of universal application as a legal measure.

A few years later, the Long Dock Company again challenged the assessments of its terminal yard and water front in Jersey City, and also of land used by it for car-storage purposes.[68] It claimed that the assessments were arrived at by the application of an arbitrary multiple. But the court upheld the assessments in an opinion from which we quote:

Both Messrs. Record and Hendrickson [witnesses for the state], as their testimony seems to indicate, testified from experience to the increment of value due to assembling and availability for special use.[69] It is now argued that such an element of value cannot be considered. . . . It is elementary that in combining two or more tracts of land for a purpose requiring both or all together, the value of the whole may well be more than the total of the parts separately. So Chief Justice Beasley, in effect, said in *Central Railroad Co. v. State Board of Assessors*, 49 N.J. L.1. If the multiple is in fact arbitrary, of course it is presumably erroneous, but if the evidence indicates that it is based on a reasonable consideration of facts, it is not made arbitrary because it happens to be a mathematical constant.

In the light of the New Jersey statute, which sets apart terminals and other Class II properties for local taxation, one can appreciate the desire of the courts, in the *Long Dock* cases, to limit the assessments to mere *market* value. But a logical adherence to this limit would preclude any valuation of Class II properties in excess of the amounts for which they could actually be sold, separately from the railroad systems of which they form an integral part. It may seriously be doubted whether the courts would be ready to go as far as this; certainly there is no indication that they have done so in the cases already litigated. Presented with the dilemma of valuing the terminals at their separate sale value and of valuing them at their value to the railroad systems that now use them, they have nominally chosen the first alternative while actually following an indeterminate middle course.

As to the assessment of the "remaining property including the franchise," the cases are surprisingly meager; presumably so because of the conservative appraisals voluntarily set by the assessors. Only

[68] Long Dock Co. v. State Board of Assessors, 89 N.J.L. 108, 97 Atl. 900 (Sup. Ct., 1916).

[69] Mr. Record also testified that the state board had not used multipliers where railroading was unprofitable. 89 N.J.L. at 113, 97 Atl. at 902.

during the early years, when the use of the "stock-and-bond" method was prevalent, was the issue discussed in any reported opinions of the courts. In the first case in point, *Central Railroad of New Jersey v. State Board of Assessors*,[70] the state board was upheld in valuing a franchise at 60 per cent of the excess value of the entire railroad (determined by the stock-and-bond method) over and above the aggregate appraised value of the tangibles. But the board was reversed in valuing the franchises of companies without any excess stock-and-bond value at 20 per cent of the annual gross earnings. The court here held that a company without any such excess value does not have any intangible value.[71]

The *Central Railroad* case involved the assessment of franchises of companies with little or no property outside the state; hence they did not present a problem of allocation. But in *West Shore Railroad v. State Board of Assessors*,[72] decided in 1911, less than 20 miles of the company's lines (including, however, its valuable terminals in Weehawken) were located in New Jersey, while 400 miles were in New York. Here the court, in testing the assessment of the franchise, deducted from the estimated stock-and-bond value of the railroad the aggregate of the appraised values of the New Jersey tangibles plus the aggregate of the *assessed* values of the New York tangibles as reported by the company. The balance (not merely 60 per cent of this balance, as used by the assessors in the *Central Railroad* case) was taken to represent the intangible value of the entire property; and a share of this value based on relative track mileage was taken to represent the value of the New Jersey franchise. As this sum ($2,190,534) exceeded by $300,000 the franchise assessment set by the state board, the assessment was upheld. The court conceded that the reported *assessed* values of the New York tangibles were probably below "true values" but held that they must be accepted in default of proof of undervaluation. A mileage allocation was held to be fair, even generous, to the taxpayer, since the great terminals were located in New Jersey. In computing stock-and-bond value, the court included the "floating indebtedness" of the company without comment and without inquiry into the purpose for which such debt was incurred, thus indicating a position contrary to the one taken in Illinois, which excludes debt incurred for current operating expenses.[73]

[70] 49 N.J.L. 1, 7 Atl. 306 (Sup. Ct., 1886).

[71] The court suggested that such a company might be subject to a nominal Class IV assessment, based on the mere cost of acquiring a railroad franchise.

[72] 82 N.J.L. 37, 81 Atl. 351 (Sup. Ct., 1911), *aff'd on opinion below*, 84 N.J.L. 768, 85 Atl. 826 (E. & A., 1913).

[73] See *infra* pp. 552, 572–574.

In the *West Shore* case, just discussed, the court suggested that a Class IV assessment computed by the stock-and-bond method need not be reduced because of low current earnings. However, a decision on this point was unnecessary, since the evidence of earnings was unsatisfactory. The court discounted the figure of the actual gross receipts and expenses because the West Shore was leased to the New York Central and used by the latter practically as a side track for the accommodation of the Central's surplus freight.[74] In *New Jersey Junction Railroad v. Hendrickson*[75] the railroad also made a claim for a reduction of its Class IV valuation because of low earnings. We quote the words of the court (per Swayze, J.):

> The bonded debt of the railroad is $1,700,000 and the bonds sell above par. The capital stock is $100,000. The total value is, therefore, $1,800,000. The main stem is valued at $1,193,000. Other real estate, $203,157, making a total of $1,396,157. The difference is $403,843. The franchise is only assessed at $246,000. In view of the fact that the railroad is leased to the New York Central and Hudson River Railroad Company for one hundred years at a minimum rental equal to four per cent on its bonded debt, we cannot say that the valuation is excessive. The small earnings of the New Jersey Junction Railroad do not change our view. They are the earnings from operation by another railroad which doubtless uses the New Jersey Junction for its own advantage; the real earnings of the New Jersey Junction are $68,000 net, clear of all taxes and expenses, that being the rental paid for its use.
>
> The assessment is affirmed, with costs.

As already noted, the state board announced in 1911 that it had changed from a stock-and-bond method of Class IV valuation to a capitalized-earnings method. Presumably it has continued this new procedure,[76] but no cases in point have been reported from the New Jersey courts.

Litigation since 1933.

Once the constitutionality of the Act of 1884 was upheld, the railroads did not challenge the basic assessment methods until 1933.[77] Instead, they were content to attack the details or else to base their complaints on alleged *relative* overassessment. In that year, however,

[74] The rental was $2,000,000 per annum, constituting a 4 per cent return on the $50,000,000 bonded debt. But under the stock-and-bond method the court valued the railroad at $68,000,000, an amount on which the rental would constitute a return of less than 3 per cent.

[75] 84 N.J.L. 413, 87 Atl. 68 (E. & A., 1913).

[76] So indicated by Hsien-Ju Huang, *State Taxation of Railroads in the United States*, pp. 39–40.

[77] See 114 N.J.L. 69 at 73, 175 Atl. 637 at 639 (Sup. Ct., 1934).

the business depression, with its critical effect on railroad earnings, caused them to strike at the very heart of the assessment procedure, by denying the whole validity of valuations based on cost data and by insisting that the aggregate of their property values must be measured by capitalized earnings or by the values of their outstanding stocks and bonds.[78] So far this attack has met defeat before the State Board of Tax Appeals and in the courts.[79] But each year it has been renewed, and the railroads are doubtless hoping to build up a record that, sooner or later, will bring them relief in the Federal courts.[80]

The general position taken by the railroads may be stated as follows. Starting with the mandate of the New Jersey constitution and statute that properties must be taxed at their "true value," the railroads insist that this value is solely dependent on net earning power; for the *value* of a business property is simply a reflection of its power to yield an income.[81] The so-called physical value of a railroad is not value at all; it is a mere misnomer for cost. To be sure, the costliness of a railroad property may have some *indirect* bearing on its value; but this bearing is very remote and, in any event, is reflected in the company's earnings record. Hence the "true value" of a railroad property must be measured either by a capitalization of net earnings, or by reference to the quoted market prices of the company's securities (prices which in themselves reflect the market estimate of earning power), or else by some combination of the two types of data. To be sure, the problem still presents itself as to what portion of the "true value" of an interstate railroad serving New Jersey represents the "true value" of the New Jersey section of the system. And there is the further problem of valuing each of the four classes of property mentioned by the statute, together with the problem of placing separate local values on the Class II properties. But these difficulties can be solved only by the appropriate use of allocation formulas, whereby each interstate railroad system is first valued as a unit and whereby

[78] The Pennsylvania Railroad system has not joined in this attack on the basic methods of valuation. Instead, it has confined its objection to that of *relative* overassessment, claiming that other property in the state is being systematically assessed at less than full value.

[79] Central R.R. of N.J. v. Martin, 57 *N.J.L. Jour.* 115 (Board of Tax Appeals, 1934), *aff'd*, 114 N.J.L. 69, 175 Atl. 637 (Sup. Ct., 1934). Same, 58 *N.J.L. Jour.* 287 (Board of Tax Appeals, 1935).

[80] See Central R.R. of N.J. v. Martin, 65 F. (2d) 613 (C.C.A. 3d, 1933), *reversing* 3 F. Supp. 477 (D.C. N.J., 1933), which had dismissed the bill on the ground that the railroads should first seek redress in the state courts, not in the lower Federal courts.

[81] For a discussion of this theory of enterprise valuation, see Chap. XII.

shares of this unitary, going-concern value are then allocated to the various parts. Any other procedure, such as that which the state now employs, inevitably results in an aggregate of assessments which, during a period of deficient railroad earnings, exceeds the va ue of the railroad system as an entirety—a situation obviously unfair to the taxpayer.

In defending its assessments against the attack thus made upon them by the railroads, counsel for the state have made many points too involved for exposition here. In part this defense has taken the form of a criticism of the precise formulas used by the railroad witnesses in their capitalization of earnings, in their stock-and-bond valuations, and in their allocation formulas.[82] In part it has relied upon the long-established New Jersey legal precedents in favor of physical valuations. To be sure, counsel concede, reproduction cost is not the same thing as "true value," nor has it been accepted as such by the assessors. But have not the courts in nearly all jurisdictions held that replacement cost, with appropriate allowances for depreciation, is persuasive *evidence* of the value of railroad properties no less than of other types of structure? And what about the decisions of the United States Supreme Court giving dominant weight to replacement-cost estimates as a measure of the "fair value" of railroad and utility properties for rate-making purposes? The argument now made by counsel for the complaining railroads that rate-making value is not "value" at all, comes with poor grace from the very companies whose counsel, in their arguments before the Interstate Commerce Commission and the courts, have ridiculed the assertion that the same property can have different values for different purposes.[83] Moreover, it is an argument that the Supreme Court has rejected in rate cases, Justice Brandeis and his dissenting colleagues notwithstanding.[84]

So much for the controversy as argued by the two contesting parties. As already noted, the State Board of Tax Appeals and the state courts

[82] It should be noted that the railroads' proof of gross overvaluation of their New Jersey properties is premised, not merely on the validity of a total enterprise valuation based on capitalized recent earnings or on stock and bond prices, but also on the validity of allocation formulas that give but little weight to the relatively high costs of the New Jersey sections of their systems—high because of the presence of extremely costly terminals on the Hudson River. If the allocation formula were to be based on the relative costs of tangible properties within and without the state, proof of overassessment in New Jersey might be difficult to adduce, even on a capitalized-earning-power or stock-and-bond basis of unitary valuation.

[83] As to the position of railway rate-case counsel on this point, see *infra* pp. 1104–1108; also *infra* p. 879, note 78.

[84] See *infra* pp. 1098–1103.

have upheld the railroad assessors. For the most part their opinions have relied on the long-continued use of the physical-valuation method and on the weight of precedent. However, they have given the method renewed approval. The opinion of the Board of Tax Appeals summarized this method as used in New Jersey, as follows:[85]

> The statute does not prescribe any specific method for determining true value. It is obvious, however, that it contemplates a physical valuation of each class of railroad property. The method of determining true value is left to the discretion and judgment of the state tax commissioner.
>
> The true value of railroad property is not determined solely by cost of acquisition of land, by cost of improvements and personal property, less depreciation, or reproduction cost less depreciation, but is based upon a consideration of many elements, such as the statutory returns made by railroad companies showing the cost and true value of their property as determined by them, a personal examination and investigation of the property, consideration of its physical conditions, usability and location and its proximity to large cities for transportation of freight and passengers and to industrial, manufacturing, and mining centers, pleasure resorts and ocean and river termini. In valuing structures and tangible personal property, additional elements are frequently considered, namely: cost, or reproduction cost, less depreciation, obsolescence and other elements not reflected in the physical value. All these elements are considered in connection with the railroad as a going concern.

In answer to the claim of the roads that "true value" can be ascertained only by the stock-and-bond or the earnings method, and that replacement cost should be given no weight, the Board of Tax Appeals replied that neither of the two methods contended for is the "sole criterion of true value"; that at best they must be considered together with other factors; and that "while some courts favor one method as being more fair than others, an examination of the opinions shows that the courts as a whole are very much inclined to the consideration of all factors." The board finally held that the method employed by the railroad assessors "meets with its approval"; and that there was no satisfactory proof of overvaluation.

The opinion of the New Jersey Supreme Court upholding the Board of Tax Appeals adds but little. It declares that "valuing railroad property for taxation is not a formulaic process"; that "there is no one and only yardstick of measurement that is used under all circumstances"; and it gave its approval, "under the proofs herein submitted," to the challenged method of valuation.

[85] 57 *N.J.L. Jour.* 115 at 116.

Comments on the Pending Controversy.

As to the merits of the above-outlined controversy the author hesitates to express an opinion, since he has himself participated as a witness for the state on certain aspects of the problem. One point, however, should be stressed because of its vital bearing on the theory of legal valuation—namely, the utter sterility of arguing the case, as both sides have done, by reference to any assumed standard of "true value." If "value" is used in any sense accepted by economists, *both* of the alternative methods of appraisal are hopelessly invalid. They are invalid because they fail to recognize that the sum of the "true values" of the various parts of a railroad system cannot possibly be equal to the "true value" of the whole. The assumption of such an equality is often made by courts and is even referred to as a "mathematical axiom." But it is clearly fallacious for reasons discussed at length in other chapters.[86]

It follows that a constitutional or statutory requirement that properties must be assessed for tax purposes at their "true values" must necessarily be violated and has, in fact, always been violated even by the courts that purport to uphold it. It is violated by assessors who, like those of New Jersey, build up their assessments by purporting to find the "true values" of the main track as distinguished from the side track, of the track as distinguished from the stations, of the entire tangibles as distinguished from the franchise, etc. But it is equally clearly violated by assessors who, following the formulas proposed by the New Jersey railroads, assume that the value of the aggregate of railroad properties in their particular state can be found by attributing to these properties some allocated "fair share" of the value of the entire interstate railroad as a going concern.

The real question presented by the New Jersey cases, therefore, is not whether the railroads in that state are being assessed at their "true values"; for any attempt so to assess them would be ridiculous. It is rather whether the particular pseudo-valuations used by the assessors constitute a more or less desirable determinant of the railroads' tax bills than the alternative pseudo-valuations proposed by the railroads. Up to a certain point, at least, the attorneys for both sides seem to be aware of this situation. But they dare not make their awareness vocal since, by so doing, they would be attacking one of the most cherished illusions of American law—the illusion that a statute or constitution should be taken literally when it declares that property should be assessed for tax purposes at its "true" or "actual" value.

[86] *Supra* pp. 76–82; *infra* pp. 677–690.

IV. RAILROAD TAX ASSESSMENTS: ILLINOIS[87]

From the standpoint of appraisal theory, the major interest of the Illinois railroad tax lies in the fact that the courts and, during certain periods of its history, the state tax administration, have approved the principle that the value of the railroad *business* should determine the sum total of the assessments. To be sure, the statute itself does not follow the logic of an "enterprise-value" appraisal, by requiring the assessment of an intrastate railroad at its single-sum value as a "going concern," and by requiring the valuation of an interstate railroad at some allocated share of this value. Instead, it has adhered to tradition by distinguishing several classes of railroad properties and by requiring separate assessment of each class. But unlike New Jersey, which uses a somewhat similar classification of railroad properties, Illinois has accepted the principle that the aggregate of its assessments should correspond to the value of the railroad enterprise, or to such a portion of this value as is under its jurisdiction. A recent opinion by the Illinois Supreme Court[88] lays emphasis on cost data as evidence of the value of railroad property and might therefore seem to imply that an assessment based largely on cost will be upheld even if it is in excess of the commercial value of the enterprise, viewed as a source of income. But the present Tax Commission has stated that it will give relatively little weight to costs; and even the opinion of the state court, which we discuss at length toward the end of this section, *may* be construed to imply that costs should be considered merely because of their indirect bearing on future earnings.

Let it be noted at the outset, however, that throughout most of its history, the administration of the Illinois railroad assessments has been woefully arbitrary. Indeed, the reconstituted Tax Commission has recently undertaken a much-needed house cleaning.

The Railroad Tax Statute of 1872.

Prior to 1872 (save for an abortive attempt at central assessment made in 1849), railroad properties were locally assessed, at first under

[87] See Illinois Tax Commission, 15th Ann. Rep. for Assessment Year 1933, especially Chap. 6; Barnet Hodes, "Assessment of Railroads in Illinois," 29 *Ill. L. Rev.* 744 (1935), and *Essays in Illinois Taxation* (Chicago, 1935), Chap. 3; John H. Fairlie, *Report on Taxation and Revenue System of Illinois* (1910), Chap. 5; Robert M. Haig, *History of the General Property Tax in Illinois* (Urbana, Ill., 1914), pp. 209–212. We are indebted to Mr. Hodes, a former member of the State Tax Commission, for valued personal correspondence.

[88] People ex rel. McDonough v. Grand Trunk Western R.R., 357 Ill. 493, 192 N.E. 645 (1934).

the general property tax and then under special statutes.[89] In that year, Illinois passed a railroad tax statute providing for assessment of railroad-operating properties by the State Board of Equalization, which had been created in 1867. Save for the transfer of its administration to the State Tax Commission, in 1919, the statute has remained substantially unchanged to the present day.[90]

Under this act, railroad property is divided into four classes, which we may here designate by numbers although the act itself does not do so.

Class I. "Railroad track," defined as the right of way and the superstructures and buildings thereon.[91]

Class II. "Rolling stock."

Class III. All other tangible property, real and personal.

Class IV. "Capital stock including the franchise" over and above the assessed value of the tangible properties—in other words, the "corporate excess."

In a later section of this chapter we shall note that the "capital-stock" tax is a general tax that likewise applies to non-railroad corporations.[92] But in both instances it is imposed only upon domestically incorporated companies. Most of the railroads serving Illinois have domestic charters. But the presence of some railroads without such charters has led the assessors, since 1877, to maximize its tangible-property assessments and to minimize, or completely to eliminate, its "capital-stock" assessments, in order to avoid discrimination against the domestic corporations. All four classes of property are subject to both state and local taxation at the rates applicable to property generally. But the procedure of assessment differs. Class III property is locally assessed. The three other classes are centrally assessed; but these assessments are to be apportioned by the board on a main-track mileage basis to the local districts in which the main track is located. An exception is made with respect to "railroad track." While the *main*-track assessment is apportioned in the manner just stated, the board must separately ascertain for each district the values of "the side or second track, and all turnouts, and all station houses,

[89] For railroad taxation prior to 1872, see the references to the Tax Commission report and to Hodes, *supra*. For decisions dealing with local assessments, see Sangamon & Morgan R.R. v. County of Morgan, 14 Ill. 163 (1852); Chicago & North Western Ry. v. Board of Supervisors of Boone Co., 44 Ill. 240 (1867).

[90] Ill. Rev. Stat. (Ill. State Bar Assn., 1935) C. 120, especially Secs. 45–57, 1 (4), 3 (4), 107 (5–6), 129.

[91] Barnet Hodes states that there has been considerable litigation over the proper definition of "railroad track." See his *Essays in Illinois Taxation*, p. 139, n. 11, citing cases.

[92] *Infra* pp. 562–577.

depots, machine shops, or other buildings" constituting part of the "railroad track."[93]

The statute does not specify any method of valuation. Nevertheless, the nature of its schedule of information, which all railroads are required to file, suggests a physical valuation of the tangible properties and a stock-and-bond valuation of the corporate excess. As to the tangibles, the schedule calls for a report of the number of ties per mile of track, the weight of iron or steel per yard of rail, the expired life of the rails, and other similar details. As to the corporate excess, the schedule calls for the amounts of the authorized and paid-up capital stock, the "market value, or if no market value, then the actual value" of the outstanding shares, the amount of all indebtedness "except for current expenses for operating the road,"[94] and the assessed value of all the tangible properties in the state.

Methods of Assessment Followed by the State Board.

In contrast with the relatively consistent assessment practice in New Jersey, the Illinois procedure has been changeable and arbitrary. At first the board assessed the tangible properties at meaninglessly low figures, and it valued the "capital stock" (that is, the corporate excess) by deducting the tangible property assessments from a total enterprise value measured by a summation of share and debt values, or from the Illinois share of such value if the road was interstate. Thus it set the aggregate assessments (for domestically incorporated railroads) at the total value (or the Illinois share of such value) of the entire enterprise as measured by the stock-and-bond method.

Later, however, the board abandoned all definite rules of valuation and reached its assessments by means which it failed to reveal. In recent years, the reconstituted board (the State Tax Commission) seems to have made a valiant effort to restore its methods of assessment to respectability. But instead of reverting to the early methods, it has placed no values on the "capital stock" and has attributed the entire railroad values to the tangible properties, which it has appraised by a composite of stock and bond prices, capitalized net earnings, and

[93] Problems of distribution to local districts will not be treated. See Hodes, "Assessment of Railroads in Illinois," 29 *Ill. L. Rev.* 744 at 760 (1935); Ill. Tax Comm., 15th Ann. Rep. (1933), pp. 198–200.

[94] Under the general capital-stock tax as applied to non-railroad corporations, the phrasing of the schedule is somewhat different as to the omission of current debt. It reads that the corporation must report "the total amount of all indebtedness, except the indebtedness for current expenses, excluding from such expenses the amount paid for the purchase or improvement of property." Ill. Rev. Stat. (Ill. State Bar Assn., 1935), C. 120, Sec. 37.

Interstate Commerce Commission "values for rate-making purposes." With interstate railroads, it has determined the Illinois share of these tangible-property values by the use of a composite allocation formula.

The Litigated Cases.

State of Illinois v. Illinois Central Railroad (1861).[95] Illinois is believed to supply the first leading tax case clearly declaring that a railroad should be valued as a business enterprise. This case, in which "A. Lincoln" is listed as of counsel for the railroad, arose before the enactment of the railroad tax statute of 1872. The Illinois Central Railroad then had, and still has, a charter exempting its "charter lines" from the general property tax. Nevertheless the charter provided that, under certain contingencies, the "stock, property, and assets" of the railroad were subject to state taxation. The state auditor levied a tax on a valuation of $19,700,000, arrived at by an unstated method. The railroad had no current net income. A witness called by the state admitted that he would not care to participate in the purchase of the road for five millions. The court fixed the valuation at $4,952,000.

Counsel for the state had argued "that the prospective value of the road should be taken into the estimate, and not its income." Judge Breese answered as follows:

> In such cases [*i.e.*, where property has no "known and determinate value ascertained by commerce in it"], if the property is devoted to the use for which it was designed, and is in a condition to produce its maximum income, one very important element for ascertaining its present value is discovered, and that is its net profits. When property is thus improved, it is manifest that it is more or less valuable, as it yields a greater or less profit, in its product and economical use. No prudent purchaser of such property would neglect, in the first instance, to look at the income the property yields, so that he might thereby judge what profits he might, in the future, reasonably expect from his investment. To ascertain what he might safely give for the property, no doubt he would, and ought, prudently, to anticipate the future, as well as regard the past, and yet, should he give more than the value as indicated by the present income, such enhanced value would be rather speculative than real, depending on a great variety of circumstances and casualties. . . . We are not prepared to say, that an assessor, making yearly valuations of property for taxation, can, or ought to take into consideration, anything more than the value of the property at the time he is called upon to value it, since, if it does increase in value in process of time, advantage can be taken of it in future valuations, as they may be periodically made. But if he can, and does, look to the future, for the purpose of ascertaining the present value of property, he should do it with extreme caution. . . .

[95] 27 Ill. 64 (1861).

We do not wish to be understood as asserting that the productiveness of property when fully improved, is an absolute standard of valuation, but that it forms a very important element in ascertaining its actual value. In connection with this, and possibly of even greater importance in forming a just opinion of real value, would be the inquiry, what would prudent men give for the property, as a permanent investment, with a view to present and future income. Both these elements were taken into the consideration of the witnesses in this case, and weighed with the court in making up its judgment.

Porter v. Rockford, Rock Island & St. Louis Railroad (1874); *State Railroad Tax Cases* (1876). A decade after the decision in the *Illinois Central* case, the legislature enacted the railroad tax statute, with its division into three classes of tangibles and the "capital stock." The state board, which was called upon to make the assessments, did not announce the method by which it proposed to value the tangible properties. But it disregarded the plain mandate of the statute by ruling that these assessments would be made without reference to the structural work underlying the rails and ties—grading, embankments, culverts, bridges, etc. Thus the appraisal of the "railroad track" was apparently confined to the bare land composing the right of way plus the rails and ties.

In consequence, the "capital-stock" assessments, which represented the difference between the valuations of the entire enterprise and the arbitrarily low values assigned to the tangibles, were relatively high, constituting from 25 per cent to 50 per cent of the board's aggregate assessments. In 1872, the board established a rule that it would determine the value of the "capital stock" by adding the market or "fair cash" value of the company's outstanding shares to the market or "fair cash" value of the outstanding debt (excluding indebtedness for current expense), and by deducting from this sum the assessed values of the tangible properties.

Immediately the Illinois railroads challenged both the constitutionality of the statute and the validity of the assessments made thereunder. They objected, particularly, to the superimposition of the novel "capital-stock" assessment upon the tangible-property assessments. But their objections did not prevail with the state Supreme Court, which upheld both the statute and the assessments, in *Porter v. Rockford, Rock Island & St. Louis Railroad.*[96]

The court disposed of the railroads' argument that "capital stock" was not taxable to the railroad since it was possessed by the individual

[96] 76 Ill. 561 (1874).

shareholders, by holding that "capital stock" here referred to the entire value of the enterprise—a value from which the tangible-property assessments were to be deducted as a measure of the corporate excess. It also held that an ad valorem tax on intangibles was constitutional; that the substitution of central assessment for local assessment was valid; that the stock-and-bond method was an appropriate method of ascertaining the value of an entire enterprise; and that the inclusion of the value of the indebtedness under this method was proper, since the taxpayer was subject to a tax on the gross value of its property, and not merely on its equity. The fact that stock-market prices were influenced by gambling transactions and manipulation was frankly conceded; but the court held that perfection in the valuation procedure was not required, and that the stock-and-bond method secured "a sufficient approximation of actual value for all practical purposes."

Having lost their case in the state courts, the railroads then went to the Federal courts and secured a decision from a lower court holding the assessments invalid. This court objected particularly to a capital-stock assessment on certain railroads that were insolvent. But in the *State Railroad Tax Cases*[97] the United States Supreme Court reversed the lower Federal court and accepted the position of the Illinois Supreme Court on all contested issues. Its opinion in this case is a landmark in the history of American tax assessment and will be discussed in another connection in the following chapter, on the unit rule. Only one quotation need be given here—the much-cited endorsement of the stock-and-bond method of enterprise valuation for tax purposes:

> It may be assumed for all practical purposes, and it is perhaps absolutely true, that every railroad company in Illinois has a bonded indebtedness secured by one or more mortgages. The parties who deal in such bonds are generally keen and far-sighted men, and most careful in their investments. Hence the value which these securities hold in market is one of the truest *criteria*, as far as it goes, of the value of the road as a security for the payment of those bonds.
>
> These mortgages are, however, liens on the road, and, taking precedence of the shares of the stockholder, may or may not extinguish the value of his shares. They must in any event affect that value to the exact amount of the aggregate debts. For all that goes to pay that debt and its interest diminishes *pro tanto* the dividend of the shareholder and the value of his share.
>
> It is therefore obvious, that, when you have ascertained the current cash value of the whole funded debt, and the current cash value of the entire number of shares, you have, by the action of those who above all others can best estimate it, ascertained the true value of the road, all its property, its capital

[97] 92 U.S. 575 (1876), *rev'g* 13 Fed. Cas. 574 (C.C.N.D. Ill., 1875).

stock, and its franchises; for these are all represented by the value of its bonded debt and of the shares of its capital stock.[98]

The Court even upheld the assessment of capital-stock values against insolvent roads. It *might* have sustained them on the ground that they were merely making good the arbitrary underassessment of the tangible properties. Instead, it held, quite correctly, that even an insolvent railroad may have a material franchise value—otherwise, its entire property would be worth no more than salvage value. On this aspect of appraisal theory, however, its language is a bit confused.

Other Tax Litigations during the 1870*'s.* After failing in their attack on the general validity of the stock-and-bond method of valuation, the railroads then challenged certain details of application. In *Chicago, Burlington & Quincy R.R. v. Cole*[99] the state Supreme Court upset an assessment of the Burlington's capital stock on the ground that the board, in using the stock-and-bond method, had erroneously included the debts of six leased railroads. These debts were not even guaranteed by the parent company, and they were rightly held not to constitute a property interest in the taxpayer itself, detracting from the value of the stock equity. The question whether or not the state *might* have assessed the lessor and lessee railroads as a unit was not raised, since the board made no attempt to do so. In a later paragraph we shall note that the State Tax Commission has now undertaken to assess railroads as entire systems rather than as separate corporations.

A few years later, the Burlington challenged the method used by the board in assessing "railroad track."[100] We have already stated that, for some strange reason, the board had omitted from these assessments many of the structural elements of a roadbed. But the court upheld the tax on the practical ground that the resulting underassessment of railroad track was offset by an automatic overassessment of the capital stock. The distribution of portions of the total enterprise value between these two classes of property was deemed immaterial. To be sure, a different situation would present itself with respect to a railroad not incorporated in Illinois, since such a company was exempted from a capital-stock tax. But the Burlington, which was a domestic road, seems not to have raised the issue.

Finally, the Ohio & Mississippi Railroad, an interstate road, objected to the main-track-mileage allocation formula by which the

[98] 92 U.S. at 604–605.

[99] 75 Ill. 591 (1874).

[100] Chicago, Burlington & Quincy R.R. v. Siders, 88 Ill. 320 (1877). See also State Board of Equalization, *Proceedings* (1874), p. 9.

board had set the Illinois share of its rolling-stock value and also the Illinois share of its enterprise value (from which was derived the Illinois share of the capital-stock value). The court[101] refused to disturb the assessment, saying that the method of allocation was a matter of judgment, that the mileage method was not necessarily unjust, and that its application to the Ohio & Mississippi was not shown to be "glaringly wrong."

Assessment Methods from 1877 to 1933.

In 1877 the state board must have changed its valuation methods; for from that year until 1901, it levied no capital-stock assessments against railroads.[102] However, it increased its tangible-property valuations, so that its total railroad assessments at first showed little decrease and soon mounted steadily. The proceedings of the board do not reveal what change in valuation methods was made, nor why it was made. But we assume that the board decided to include in the assessments of "railroad track" the entire roadbed structures and not merely the land, ties, and rails. No doubt the reason for the change lay in the desire to avoid discrimination against domestically incorporated roads, which alone were subject to the capital-stock tax.

From the 1880's down to the 1920's the data on railroad tax valuation are scanty indeed—almost nonexistent. During this period the courts pronounced many dicta, in cases otherwise of no special interest to this section, to the effect that a railroad should be assessed as a unit.[103] But what methods the state board used are a mystery. In all probability the assessments were arrived at by a bargaining process between the board and the taxpayers, influenced by politics, and guided by some rough standard such as approximate values per mile or per train.

The methods of valuation used from 1919 to 1933 are described as follows in a recent report of the Illinois Tax Commission:[104]

[101] Ohio & Mississippi R.R. v. Weber, 96 Ill. 443 (1880). Compare the method sanctioned by the Illinois Supreme Court of arriving at the capital-stock assessment of a non-railroad corporation owning property in other states: *infra* pp. 574–575.

[102] From 1901 through 1931, the capital-stock assessments were relatively small, totaling 2 or 3 million dollars per year, as compared to total board assessments ranging from 86 to 716 million. As will be noted later, no capital-stock assessments have been levied since 1931.

[103] See People ex rel. City of Chicago v. State Board of Equalization, 205 Ill. 296, 68 N.E. 943 (1903); People ex rel. Thompson v. Illinois Northern Ry., 248 Ill. 532, 94 N.E. 37 (1911); People ex rel. Carr v. Illinois Central R.R., 307 Ill. 265 at 268, 138 N.E. 593 at 594 (1923).

[104] Ill. Tax. Comm., 15th Ann. Rep. (1933), pp. 178–179.

With the creation of the Tax Commission in 1919 a representative of the Wisconsin Tax Commission was brought to Illinois to install the "Wisconsin System." This method consisted in the unit valuation of railroads by systems and the apportionment to Illinois of its share of the total values thus derived. In making these apportionments, stock, bond, earnings, and other data were taken into account. The forms devised in 1919 elicited a minimum of information upon which unit value assessments could be based.

For approximately two years the Wisconsin method apparently was followed, after which time employees of the Tax Commission began to make assessments on a physical basis—that is, engines, cars, miles of track, and other parts of a railroad were assigned definite values and the assessment was made by multiplying these values by the number of units owned or operated, as taken from the returns filed by the carriers. The Commission assigned its own values to the various factors apparently without much reference to values reported by the railroads or carried by the Interstate Commerce Commission. This pseudo-appraisal method continued for a number of years, when it was superseded by assessments based upon a "conference plan." Under this system members of the Tax Commission, or its staff, met with the railroads at a hearing, at which the assessments were determined. During this time little attention was paid to the forms required of the railroads. . . . When assessments were made by conference between the Tax Commission and the railroads, the resulting valuations represented the bargaining ability of the various parties. The consequence of the procedure was that assessments of railroads in Illinois came to have little relationship to other types of property, and between the railroads themselves gross inequalities inevitably developed because some railroads were better bargainers than others. Nevertheless, those familiar with railroad and other assessments in Illinois were generally of the opinion that these corporations were assessed on a relatively higher basis than other taxpayers in Illinois. There is a considerable volume of data to substantiate this contention.

New Method of Assessment Instituted in 1933.

In 1933, the Tax Commission, newly constituted under the regime of Governor Horner, issued the report previously mentioned, in which it announced the abandonment of the bargaining procedure in favor of fairly objective appraisal methods. The railroads are required to file the following information, employing the same basic data that are reported to the Interstate Commerce Commission:[105]

1. Market value of stocks and bonds for previous 5 years, based on the average of the high and low monthly quotations, and averaged for each year.
2. A statement showing in detail the value of nonoperating property.
3. The net railway operating income for line within and without Illinois for each of the previous 5 years and the average thereof capitalized at 6 per cent.

[105] Ill. Tax. Comm., 15th Ann. Rep. (1933), p. 180.

4. The Interstate Commerce Commission original valuation plus additions and retirements, less depreciation, to Dec. 31, 19—, for Illinois.

5. The railway operating revenues for each of the previous 5 years and the average thereof for the period for entire line, and for Illinois (intrastate and allocated interstate).

6. If the railroad operates lines in other states than Illinois, the following information on allocation factors: the ratios of miles of road, gross operating revenues, Interstate Commerce Commission valuations, traffic units, and use of rolling stock in Illinois to corresponding totals for the entire system for each of 5 previous years and average thereof.

7. A copy of their latest annual report to stockholders and a map showing the location of their road in Illinois with each branch as now assessed separately marked.

8. Any other data deemed pertinent.

The above information clearly points to a "composite method" of valuation, which receives emphatic endorsement in the report. In order to compute system value, the commission uses a composite of capitalized earnings, stock and bond quotations,[106] and physical values "as indicated by the Interstate Commerce Commission and other appraisals." Earnings are capitalized at 6 per cent. Presumably, earnings and stock and bond values are computed over a 5-year period, although the reports do not say so specifically. "Primary emphasis," says the report, "should be given to earnings and stock and bond quotations in the valuation process."

For purposes of allocating to Illinois its share of the values of interstate railroads, the commission uses a composite of all-track miles, gross operating revenues (method of allocating revenues from interstate traffic not specified), traffic units (ton and passenger miles), rolling-stock mileage (car and locomotive miles), and Interstate Commerce Commission valuations brought down to date. The report criticizes

[106] In Mobile and Ohio R.R. v. Schnipper, 31 F. (2d) 587 (E.D. Ill., 1929), the court, in discussing stock-and-bond value, said that "tax-exempt property and noncarrier property should be deducted from the market value of securities." See also People ex rel. McDonough v. Grand Trunk Western R.R., 357 Ill. 493 at 495, 192 N.E. 645 at 646 (1934), treated *infra* p. 561. The state board, in commenting on this statement in the Mobile & Ohio case, said that it "is not only sound in theory, but conforms to the actual practice adopted by this Commission." 15th Ann. Rep. (1933), p. 188. In the case of capitalized earnings, such a deduction is not necessary, as only railway *operating* income is capitalized. Much of the railway "noncarrier" or "nonoperating" property located in Illinois comes within the class of property assessable by the local assessor; but not all. Intangible assets, such as stocks, bonds, moneys, and credits belonging to railroads, come within the purview of the state board and not of the local assessor. Illinois Central R.R. v. Carr, 302 Ill. 172, 134 N.E. 138 (1922). Unless the state board levies capital-stock assessments against railroads to cover these intangible assets, which it has not done so far under the "new method," these assets escape taxation.

each of these allocation factors when used alone, but it concludes that their combined use will result ordinarily in a mutual cancellation of errors. There is no indication whether these factors are equally or unequally weighted. The report suggests that the commission may reduce the allocation factors to three, by the omission of all-track mileage and rolling-stock mileage.

It should be noted that the Illinois roads are now to be valued, not according to separate corporate entities, but by systems. On this point the report comments as follows:[107]

> In previous years railroads were assessed by corporate ownership, branch divisions or other units, at the option of the companies filing the returns. No attempt was ever made to consolidate the operating units or the separate ownership units into single systems. . . .
>
> It has been the policy of this Tax Commission, however, to consolidate all returns on a system basis, so that every operating unit is responsible for the assessment of all subsidiary corporations. The operations of each line were considered as a unit and the valuations were placed against the systems as a whole.

Under the new method of valuation, the aggregate of the commission's assessments fell from $555,000,000 in 1932 to $492,000,000 in 1933, the first year under the new method. Even in 1932 all capital-stock assessments were omitted, for the first time since 1901, nor were they restored in 1933. In the future, little use will probably be made of these assessments under the new method.[108] In fact, this method is obviously designed to minimize the distinction between tangible and intangible values. As far as the present statute will permit, it attempts to identify the entire value of a railroad with enterprise value.[109]

So far, the change in method has not resulted in any court litigation, presumably because it has produced a substantial decrease in assessments. However, of the two recent cases dealing with prior assessments, that in 1929 by the Federal District Court for Illinois clearly supports the new method, while that by the state Supreme Court in 1934 indicates that this court attaches far more significance to original and replacement costs than does the Tax Commission. In *Mobile &*

[107] At pp. 163–164.

[108] But see note 106, *supra,* pointing out that only by capital-stock assessments is it possible to reach those nonoperating assets, taxable in Illinois, that are assessable by the state board and not by the local assessor.

[109] In a letter to the writers, dated Apr. 22, 1936, Barnet Hodes, a former member of the Tax Commission and present corporation counsel of Chicago, states that under the new method, "it is clear that a foreign road is assessed, in theory at least, in the same way as an Illinois road."

Ohio Railroad v. Schnipper (1929),[110] the railroad, listed by the commission as an Alabama corporation, challenged its assessment of $6,797,999, on the ground that it represented the full value of the Illinois portion of its road, although other property was assessed below full value. The court found that other property was generally assessed at no higher than 47 per cent of full value. Evidence was submitted on earnings, stock and bond capitalization, and cost. The court capitalized the average net earnings (after a deduction for taxes) during the preceding 4-year period at 6 per cent, and arrived at a system value of $53,293,760. It added to the face amount of the bonds and equipment-trust obligations, a value of the shares which it computed by assuming that, since the road was earning $30 per share, the fair market value per share was $290. This addition resulted in a figure of $52,671,-720. Why the market quotations of the bonds and the shares were not in evidence was not explained by the court. As to the cost data, the story may best be told in the court's words:[111]

The defendants produced a witness who testified as to certain calculations he had made from certain figures in the office of the Interstate Commerce Commission, using a purely theoretical formula for the purpose. He took from the records of the commission the cost of reproduction of the railroad equipment and rolling stock of plaintiff, less depreciation, as of June 30, 1915. From this he deducted the actual retirements, as reported by the company to the commission, and to it he added the additions as reported by the company from time to time. He did not examine the property with a view to determining its actual value, or the actual depreciation thereon. He appreciated by straight line or curved methods the already depreciated cost of reproduction of the items inventoried in 1915 by sometimes as much as 224 per cent. He appreciated each of the additions by arbitrary percentages, and then depreciated each of the appreciated values by certain straight line or curved formulae, without any personal knowledge or examination of the property itself, and without any basis for determining the cost at the present time, less reproduction [*sic:* evidently should read "depreciation" instead of "reproduction"], other than the theoretical formulae adopted by him. The

[110] 31 F. (2d) 587 (E.D. Ill., 1929). Referring to this case, an Illinois tax expert writes: "Not a single representative of the State Tax Commission or of the Attorney-General's office was present at the trial, though local attorneys for the counties [the defendants were the tax collectors for the various counties through which the railroad runs] asserted that they had appealed to both departments for aid. The consequence was that no one in court knew the basis of the assessment in question. . . . The case for all intents and purposes went by default." Herbert D. Simpson, *The Tax Situation in Illinois* (Institute for Research in Land Economics & Public Utilities, Studies in Public Finance, Research Monograph No. 1, 1929), pp. 71–72.

[111] 31 F. (2d) at 591–592.

witness furnishes no evidence as to whether any of the machinery, locomotives, or other mechanical equipment or rolling stock has become less valuable because of obsolescence, or because of less efficiency as compared with more modern machinery. . . .

Evidence of cost of reproduction, less the actual depreciation of the property, is always competent and desirable evidence upon the question of values, if the witness who furnishes the same has actual knowledge of the cost units which go into its reproduction, and of the actual condition of the property so far as depreciation is concerned. But this court will not accept with any credence the theories of a witness, as to costs, which attempt to set up a depreciated cost of reproduction in 1915, then to appreciate the same, then to depreciate again, and to appreciate all additions, and then to depreciate them, and thus to arrive at a purely hypothetical value in 1926, without any showing of any knowledge of construction or property units.

There is unnecessary confusion in the remarks of different courts as to so-called difference between values for taxing purposes, and for other purposes. To the mind of this court, value is always the same. . . . If all property were at all times assessed at its full value, . . . there would not creep into briefs of lawyers or decisions of courts decisions or remarks to the effect that valuations for tax purposes are different from valuations for rate-making purposes.

In the matter of allocation, the evidence was meager. It was shown that 16.77 per cent of the mileage (whether main track or all track not stated) owned, and 14.6 per cent of the mileage operated by the road, was located in Illinois; that the road owned no terminal facilities in Illinois; and that the expenses of operation in Illinois were greater than in other states because of more curves and sharper grades. The percentage of the entire earnings that was earned in Illinois during the preceding 5-year period amounted to 11.41 per cent, or, excluding the earliest year since it showed a deficit for Illinois, 14.27 per cent. If the next earliest year had also been excluded, since it showed a percentage almost zero, the 3-year average would have amounted to 17.48 per cent. As the court did not reveal the basis upon which earnings were allocated, the significance of this evidence cannot be determined.

After considering all the above evidence, the court concluded that the maximum value reasonably allocable to the Illinois portion of the road was $8,599,830. The highest allocation percentage that the court had computed, 16.77 per cent of mileage owned, multiplied by the highest system value computed, $53,293,760 (based on average net earnings over a 4-year period capitalized at 6 per cent), gave $8,837,364. As the assessment greatly exceeded the maximum figure as equalized at 47 per cent, $4,041,920, the court enjoined the collection of taxes on any sum in excess of this latter figure.

From the opinion in this case it is apparent that the evidence upon which the court relied was inadequate. Nothing was said as to the market prices of the shares, as to allocation factors other than those based on mileage and earnings, and as to the method of estimating the Illinois share of these earnings (a ticklish problem in railroad accounting). The court did not discuss the technical question as to which party should sustain the burden of proof with respect to the different types of evidence; but its decision suggests that a heavy burden was placed upon the government.

People ex rel. McDonough v. Grand Trunk Western Railroad (1934).[112] Five years later, the state Supreme Court, in the case just cited, rendered a decision which, in effect, conflicts with that of the Federal court in *Mobile & Ohio v. Schnipper*. The opinion also reveals disagreement with the views of the Tax Commission, which has assigned minor importance to original and replacement cost. The full value of the Illinois portion of the Grand Trunk Western Railroad as found by the commission was $5,810,860. The road proved its "stock-and-bond" value, using market prices as of April 1, 1930, the assessment day;[113] and its "earning value," using a 6-year average of earnings capitalized at 6 per cent. It proved the Illinois share of these values by the use of a composite allocation formula based on "track miles, gross income, and other factors." The allocated "stock-and-bond" value was $3,522,750; and the allocated "earning value," $3,824,198. The holding of the court may be given in its own words:

> No testimony was offered to establish the value of the objector's property proving reproduction costs less depreciation and obsolescence, nor the method commonly called "historical cost," which is original cost, plus the cost of betterments. These factors of reproduction costs and historical cost are important, although not necessarily controlling, in determining the fair cash market value of a railroad property [citing, *inter alia*, United States Supreme Court rate-making cases].
>
> . . . The burden was on the objector to overcome, by clear and explicit evidence, the valuation placed by the tax commission on the objector's property. Such proof must show not a mere error of honest judgment in fixing such value by the taxing authorities, but must show such lack of knowledge of values or such arbitrary acts in fixing values as amounts to constructive if not actual fraud.

[112] 357 Ill. 493, 192 N.E. 645 (1934).

[113] The court did not comment on the use of stock and bond prices of a single day. Its decision suggests that it considered such evidence inadequate proof of stock-and-bond value.

However, as the Tax Commission had equalized the "full value" at 60 per cent, whereas it should have taken 27 per cent, the court ordered the adoption of the latter percentage.

This decision *may* be construed as a holding that an assessment based on cost data will be upheld even if it is generally in excess of a valuation that would be reached by the stock-and-bond method or by the capitalized-earnings method. Even if so interpreted, it is not inconsistent with the position that the value of a railroad depends entirely on *prospective* earnings, and that the costliness of the property is to be given weight merely because of its indirect bearing on future earning power. But the only *necessary* conclusion from the case is that a court will refuse to upset an assessment except in the light of a comprehensive body of evidence, including adequate data on structural costs, to be presented by the complaining taxpayer.

V. VALUATION UNDER A CORPORATE-EXCESS TAX: THE ILLINOIS CAPITAL-STOCK TAX[114]

Most of the cases in which the principles of the general property tax have been abandoned or modified in favor of a tax based on *enterprise* value, are cases arising under special statutes applicable to railroads or other public utilities. With nonutility enterprises, local assessment of the tangible properties, based on methods of appraisal discussed in the previous chapter, still prevails. Nevertheless, several states have superimposed on their general property tax, special corporation taxes, often called "capital-stock" or "franchise" taxes, designed to tax the value of the entire enterprise in excess of the assessed or appraised values of the tangibles. In the literature of public finance, these taxes are called "corporate-excess" taxes.

The example chosen for our study is the Illinois capital-stock tax. Already we have discussed it in its application to railroad companies. But as applied to other corporations it requires separate treatment, since it does not here tie in with a central assessment of the tangible properties. From the standpoint of appraisal theory, its chief interest lies in the almost sole reliance placed by the Illinois courts on the stock-and-bond method of enterprise valuation.[115]

[114] See Barnet Hodes, "The Illinois Capital Stock Tax," 28 *Ill. L. Rev.* 332 (1933), and *Essays in Illinois Taxation;* Joel Moore, "Taxation of Corporations in Illinois Other Than Railroads Since 1872," University of Illinois, *Studies in the Social Sciences*, Vol. II, No. 1 (1913); Robert M. Haig, *History of the General Property Tax in Illinois;* Ill. Tax Comm., 15th Ann. Rep. for the Assessment Year 1933.

[115] For a critique of this method from the standpoint of appraisal theory, see Chap. XII, at pp. 244–249. Compare the preference for a composite

The Statute.[116]

The Illinois capital-stock tax has been in effect, with various modifications, since 1872. In this state the tangible properties of all non-railroad corporations are locally assessed. No further ad valorem tax is imposed on foreign corporations doing business within the state, although the shares and creditor instruments of such corporations are subject to the general property tax, payable by the individual owners. But domestic corporations (including companies also incorporated in other states[117]) are subject to a tax upon the "fair cash value of the capital stock, including the franchise, over and above the assessed value of the tangible property." The shares of these corporations (but not the bonds) are exempt from taxation.[118]

A ridiculous distinction is made between two groups of domestic corporations. With companies organized for purely manufacturing or mercantile business, for the mining and sale of coal, for the publication of newspapers, for printing, or for the improvement and breeding of livestock, the corporate excess is assessable by and payable to the local district in which the principal office is situated.[119] But with other

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method under the Federal capital-stock tax (*infra* pp. 577–595), and for a capitalized-earnings method under the New York special-franchise tax (*infra* pp. 595–613).

[116] The sections relating to the capital-stock tax are scattered throughout the Illinois revenue law. See Ill. Rev. Stat. (Ill. State Bar Assn., 1935) C. 120, especially Secs. 1 (4), 3 (4), 107 (6), 108 (10).

[117] Quincy Bridge Co. v. Adams County, 88 Ill. 615 (1878); Ohio & Mississippi R.R. v. Weber, 96 Ill. 443 (1880).

[118] Corporations, whether domestic or foreign, are also subject to an annual "franchise tax" of one-twentieth of 1 per cent upon the amount of their total paid-in capital distributable to Illinois upon the basis of relative property owned and business transacted in Illinois and everywhere. Ill. Rev. Stat. (Ill. State Bar Assn., 1935), C. 32, Secs. 131–134, 138–140 (1). Since 1935, telegraph, telephone, water, gas, and electric companies have been subject to a tax upon their intrastate gross receipts—3 per cent until 1937, 2 per cent thereafter. *Ibid.*, C. 120, Secs. 440–453.

[119] The statute exempts these companies from corporate-excess assessment; but the Illinois Supreme Court has held such exemption invalid. It has further held that the law, in so far as it exempts such companies from assessment *by the state board*, is valid in that particular, and therefore that only the *local* assessor may assess their corporate excess. Consolidated Coal Co. v. Miller, 236 Ill. 149, 86 N.E. 205 (1908); People ex rel. Edgar v. National Box Co., 248 Ill. 141, 93 N.E. 778 (1910); People v. Lewy Bros. Co., 250 Ill. 613, 95 N.E. 984 (1911). See People v. Federal Security Co., 255 Ill. 561, 99 N.E. 668 (1912).

However, the state board has the power to prescribe methods of assessment for the local assessors; and since 1919, these assessors have been required to follow Rule Eleven of the board, discussed below. The assessment of corporate excess by local assessors has probably been even more erratic and inefficient than that

corporations, of which the various public utilities form by far the most important class, the assessment is made by a state board[120] and is transmitted to the local district of the principal office, where a tax is imposed at the regular property-tax rate of the district.

Without specifying any methods of valuation, the statute empowers the state board to adopt such rules of assessment "as to it may seem equitable and just," and declares that these rules, "if not inconsistent with this act, shall be as binding and of the same effect as if contained in this act." Nevertheless, the use of the stock-and-bond method is suggested by the types of information expressly required. They include statements of the authorized and paid-in capital stock; the "market value, or if no market value, then the actual value of the shares of stock"; "the amount of all indebtedness except the indebtedness for current expenses, excluding from such expenses the amount paid for the purchase or improvement of property"; and the assessed values of the tangibles. Data on gross or net earnings are not mentioned, but the board apparently has authority to require additional information.

The Stock-and-bond Method as Embodied in Rule Eleven.

Soon after the enactment of the capital-stock tax, the state board, in 1873, issued its "Rule Eleven" governing the methods of assessment. With minor modifications, this rule has been at least nominally in force down to the present day and has been repeatedly approved by the state courts. We quote from it extensively, in its more recent phraseology:[121]

For the purpose of ascertaining the fair cash value of the capital stock, including the franchise, of all companies and associations now or hereafter created under the laws of this state, and for the assessment of the same or so much thereof as may be found to be in excess of the equalized valuation of the tangible property of such companies and associations, respectively, the fair cash value of the shares of capital stock (consideration being given among other things, to the value of the shares of stock and the quotations of such shares in the market over such a period of time as may be reasonable, also the books of said corporations and the returns heretofore made to the Auditor of Public Accounts or the Tax Commission, and such information as the Tax

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by the state board. See Ill. Tax Comm., 15th Ann. Rep. for Assessment Year 1933, especially pp. 219 *et seq.*; Barnet Hodes, "Illinois Capital Stock Tax," 28 *Ill. L. Rev.* 332 at 353 (1933).

[120] By the State Board of Equalization until 1919; by the State Tax Commission from 1919 onward. In this chapter the term "board" or "state board" refers to either of these administrative bodies.

[121] Quotation from Hodes, "Illinois Capital Stock Tax," 28 *Ill. L. Rev.* 332 at 335, n. 20.

Commission has or may be able to obtain) and the amount of indebtedness (except indebtedness for current expenses excluding from such expenses the amount paid for the purchase or improvement of property) shall be combined or added together.

The Tax Commission shall then equalize said amount so obtained, so that said companies or associations shall be assessed as near as practicable upon a uniform basis with other property throughout the state.

From the aggregate amount so determined and equalized as aforesaid, there shall be deducted the aggregate equalized valuation of all tangible property of such corporation or association, respectively, and the remainder if any shall be taken and held to be the assessed value of the capital stock of such corporation or association including the franchise over and above the tangible property thereof.

The most significant aspect of Rule Eleven is its acceptance of the stock-and-bond method of arriving at the total enterprise value, from which the assessed value of the tangibles is to be deducted. But during certain periods of its history, the board failed grievously to adhere to its own rule. Instead, it was guilty of gross inefficiency and of the most arbitrary procedures. On several occasions it was sharply called to account by the state courts, which declared its assessments "fraudulent." In 1900 it attempted to abandon Rule Eleven in favor of a new rule clearly violative of the statute—an attempt which, as will be noted later, was frustrated by the courts in a mandamus action instituted by a Chicago teachers' association. Under Governor Horner's administration in the 1930's, a serious attempt at house cleaning seems to have been made. But the previous history of the actual administration of the tax supplies more lessons in politics than in appraisal theory.

General Validity of the Stock-and-bond Method.

The legal history of the Illinois capital-stock tax is of special interest as furnishing perhaps the strongest line of precedents in favor of the stock-and-bond method of enterprise valuation. But this history is of no less interest as illustrating a tendency on the part of the lower Federal courts to belittle this method of appraisal and to assume the superiority of the capitalized-earnings method.

The earliest litigation under this tax was instituted by railroads and has already been discussed in our section on Illinois railroad tax assessments. In *Porter v. Rockford, Rock Island & St. Louis Railroad,*[122] decided in 1874, the state Supreme Court upheld the statute in general and the validity of the stock-and-bond method of appraisal in particular.

[122] 76 Ill. 561 (1874).

When the railroads finally took their grievance to the United States Supreme Court,[123] Justice Miller, speaking for the Court, gave an unqualified endorsement of the stock-and-bond method:

> It is therefore obvious, that, when you have ascertained the current cash value of the whole funded debt, and the current cash value of the entire number of shares, you have, by the action of those who above all others can best estimate it, ascertained the true value of the road, all its property, its capital stock, and its franchise; for these are all represented by the value of its bonded debt and of the shares of its capital stock.

Fortified with this opinion by the country's highest court, the Illinois courts have continued to approve the stock-and-bond method of valuation under the corporate-excess tax. In *Ottawa Glass Co. v. McCaleb* (1876),[124] the application of the method to a non-railroad enterprise was approved on the authority of the *Porter* case. Soon thereafter, in *Pacific Hotel Co. v. Lieb* (1876),[125] an assessment based on the same method was upheld even though the shares were concededly worthless. It was here held that the entire enterprise might be appraised at a value measured by the current market values of the creditor claims alone.

The Illinois Supreme Court not only sustained assessments made on the basis of the stock-and-bond rule; in the leading case of *State Board of Equalization v. People ex rel. Goggin*,[126] it directed the issuance of a mandamus to the state board, commanding it to assess, under its stock-and-bond rule, the corporate excess of a large number of Chicago public-utility corporations which had escaped with little or no assessment. Shortly after the application for this mandamus had been filed by an irate body of Chicago school teachers, the board rescinded its stock-and-bond rule, and adopted in lieu thereof an ambiguous rule of assessment which, among other things, indicated that the corporate enterprise should be valued merely on the basis of the market value of its *shares*, without reference to the debt. Were this rule to be applied, companies with a heavy funded debt would be found to have no value in excess of the assessed value of their tangible properties. In addition, the new rule implied that in the valuation of a corporate enterprise, abatement should be made for any payments made by a corporation to

[123] State Railroad Tax Cases, 92 U.S. 575 (1876), *rev'g* 13 Fed. Cas. 574 (C.C.N.D. Ill., 1875).

[124] 81 Ill. 556 (1876).

[125] 83 Ill. 602 (1876); see Keokuk & Hamilton Bridge Co. v. People, 161 Ill. 132 at 143, 43 N.E. 691 at 695 (1896). See also State Railroad Tax Cases, 92 U.S. 575 at 606 *et seq.* (1876).

[126] 191 Ill. 528, 61 N.E. 339 (1901).

local communities as compensation for the use of its franchise privileges. This rule was invalidated by the court, which commanded the state board to assess the corporations according to its Rule Eleven. It declared that the principles embodied in that rule were well adapted to produce the result desired, had been uniformly applied by preceding state boards of equalization, and had met the approval of this court as well as of the Supreme Court of the United States.[127]

On one point the writ of mandamus,[128] as confirmed by the Illinois Supreme Court, departed from the rule of valuation prescribed by the board in its early version of Rule Eleven. This version had required that the corporate indebtedness be included at its "market or fair cash value." But the court's writ called for the inclusion of the "*amount*" of the indebtedness, a word that is ordinarily taken to mean face value rather than market value or actual value. One suspects that this change was made inadvertently, since both the lower and the upper courts, in other parts of their opinions, expressly approved the earlier phrasing of Rule Eleven. But the board, in restoring this rule, amended it so as to include the debt at its "amount." Needless to say, this change is in violation of sound appraisal theory in so far as it applies to a company with a bonded debt worth, on the market place, an amount differing materially from face value. We have little doubt but that, if the issue arises again, the courts will recognize this point.

Finally, the Illinois courts have upset assessments severely out of line with a stock-and-bond valuation. In the first of these cases, *Calumet & Chicago Canal & Dock Co. v. Stuckart* (1916),[129] the complainant proved that its assessments were not warranted by a stock-and-bond result and that the state board had not examined its books. It presented no proof of net earnings, book value, or cost. The lower court gave judgment for the complainant. The defendant tax collector appealed on the ground that the evidence was insufficient to sustain the judgment; but in what respects the evidence was claimed to be

[127] 191 Ill. at 546, 61 N.E. at 346.

[128] The writ required that the board and each member thereof "shall, from the best information obtainable by it and them, ascertain and take into consideration, among other things, as to each said corporation as the same was on the first day of April, 1900 [the statutory assessment date], the market value, or if no market value, then the fair cash value, of its shares of stock and the total amount of all its indebtedness, except the indebtedness for current expenses, excluding from such expenses the amount paid for the purchase or the improvement of property, and the assessed or equalized valuation of all tangible property of said corporations, respectively, on said April 1, 1900." 191 Ill. at 552, 61 N.E. at 348.

[129] 275 Ill. 253, 113 N.E. 894 (1916); [Same] v. O'Connell, 265 Ill. 106, 106 N.E. 452 (1914).

inadequate was not revealed in the opinion. The state Supreme Court affirmed the judgment, saying:

> While the board is not necessarily bound by the market quotations of the shares of stock in determining their value [the complainant had no indebtedness], these cannot be disregarded and an assessment made without evidence and in violation of the rules of the board sustained. . . .

In the other of these cases, *People ex rel. Little v. St. Louis Electric Bridge Co.* (1919),[130] the complainant presented the original and replacement cost of its bridge, the value carried on its books, its earnings for the 6 years during which it has been in operation, the testimony of experts as to the price its bridge would sell for, various circumstances affecting its business prospects, and the face or par values (but not the market values) of its debt and of its outstanding shares. On the basis of these data the company challenged not only its corporate-excess assessment but also the tangible-property assessment placed upon its bridge by the local assessors.

Both assessments were held invalid. As to the local assessment, the court took into account all the "evidence of value" adduced by the taxpayer, except stock-and-bond value. As to the assessment of the corporate excess, the court paid sole attention to stock and bond values, which it found inadequate to justify the board's appraisal. "An assessment," it said, "arbitrarily made by the board in violation of its own rules cannot be sustained."

In this particular case, the court accepted the face value of the debt and the par values of the shares as the upper limit of their actual values. But it did so expressly on the ground that, in view of the company's low earnings, the shares could not possibly have had a market value in excess of par. In fact, both the corporate-excess assessment and the tangible-property assessment were insupportable on the basis of *any* of the presented evidentiary data—cost, past earnings, and future prospects.

In *People ex rel. Little v. St. Louis Merchants Bridge Co.*,[131] decided in the same year, another interstate bridge company complained both of its tangible-property assessment and of its corporate-excess assessment, which were derived from valuations exceeding by one-third the face amounts of the debt and of the outstanding shares. It introduced evidence of original and replacement cost, neither of which supported either assessment. It proved that its shares were owned and closely held by an association of fourteen railroads and had no established

[130] 290 Ill. 307, 125 N.E. 280 (1919).

[131] 291 Ill. 95, 125 N.E. 752 (1919).

market price; and that the bridge was operated by these railroads on a cost basis, thus producing no net earnings after charges for maintenance, repairs, interest, and taxes. But the taxpayer failed to produce evidence tending to show what the earning capacity of the bridge *would* be if it were operated on a profit basis by an independent company. This failure was held fatal to the taxpayer's case, and the assessment was sustained. Dunn, C. J., spoke for the Illinois Supreme Court:

> The ownership of the capital stock of the appellee and the manner in which its property was used by the beneficial owners were such that the fact that the stock had no market value, that no dividends were paid and that there were no earnings above interest, taxes and repairs, were by no means conclusive that the franchise of the corporation had not an actual, substantial value in excess of the value of its tangible property. The record does not show what was the net value of the service rendered by the bridge of the appellee to its owners if measured by the ordinary method of measuring the value of such service. In the absence of knowledge of such value it cannot be said that . . . the value fixed by the State Board of Equalization was so excessive as necessarily to be fraudulent.

Although, as already noted, the Illinois courts have used the stock-and-bond method as the controlling test of the validity of a corporate-excess assessment, none of the cases decided by these courts has presented a clear-cut conflict between the results obtained by a reasonable application of the alternative methods of capitalized net earnings and security prices. That is to say, in all of these cases, so far as one may judge from a reading of the opinions, the actual decision to sustain or to invalidate the assessment *might* have been the same, even if it had been rendered by a court which belittled the stock-and-bond test and which accepted an earning-power test. The nearest approach to a *decision* justifiable only under the former criterion, was that in the *Calumet & Chicago Canal & Dock Co.* case, already discussed, in which a finding that the assessment was not warranted by this criterion was deemed sufficient to invalidate the tax without more.

But in the one case in which a *Federal* court has faced this issue, as arising under the Illinois capital-stock tax, this court upset the assessment largely by reference to a capitalized-earnings test, without even making any inquiry as to whether it would meet the stock-and-bond-value test: *Chicago Union Traction Co. v. State Board of Equalization,* decided in 1902.[132] From a legal standpoint such a procedure

[132] 112 Fed. 607 (C.C.S.D. Ill., 1901); 114 Fed. 557 (1902), *aff'd,* 207 U.S. 20 (1907). The Supreme Court's opinion is limited to questions of jurisdiction and

is questionable in view of the tradition that the Federal courts should follow the highest state court in the interpretation of a state statute, at least in the absence of a question of Federal constitutionality. But a discussion of this point is beyond the scope of our treatise.

The Federal case was an aftermath of the writ of mandamus issued in *State Board of Equalization v. Goggin,* discussed above. Immediately after the *Goggin* decision was rendered, the affected public utilities asked the Federal Circuit Court to restrain the state board from complying with the writ of mandamus. They apparently argued that the board, being subject to the restrictive provisions of the mandamus, "will not now exercise its independent judicial function, but will confine itself to the mere arithmetic of adding together the indebtedness and stock-exchange quotation"; and that the "due-process" and "equal-protection" clauses of the Federal Constitution entitled them to the "discretion" of the board, which should be free to consider all relevant evidence of value without being bound by stock and bond quotations.

In refusing to grant an injunction, the Federal court said that the mandamus was not intended to deprive the board of its honest discretion. By way of dicta, it also commented on the methods of estimating enterprise value. Stock-and-bond value, it said, is only one of the "indicia" or "criteria," and "not the ultimate measure." It should not be turned into a "fast rule" of valuation. The court's objections to the stock-and-bond method are given in the following quotation:

But while the capital stock is what might be called the equity over and above the indebtedness, it has a stock-market quotation not measured solely by its intrinsic value. The court knows by experience and observation that railroad properties when sold as an entirety, almost without exception, yield nothing to the stockholder, although the stock may have been sold in share lots upon the stock exchange for years previously at advanced figures. The court knows, also, from observation that the speculative public, dealing in stock sales, and making its quotations, are governed largely by the prospect of present dividends, and not by any general conception of permanent earning capacity. These, and other considerations that could be mentioned, make stock quotations an indicia, but an unstable indicia, of the real value of the capital stock as an entirety. In the case of non-dividend paying stocks, the above and, perhaps, other considerations are pertinent. In the case of dividend paying stocks, the market quotations of capital stock, averaged for a reasonable period of time, say five years, and during normal business conditions, would afford a fair measure of value, and should be a strong con-

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equalization, without reference to the relative merits of the stock-and-bond and capitalized-earnings methods.

sideration in fixing the same. Earning capacity too, for the time being, may be the result of exceptional management of frugality. The state does not mean to tax this, but only the inherent value of the property itself.

Following the refusal of the Federal court to interfere, the state board redetermined its assessments of the properties in question. Again the utilities went to the Federal court, this time to nullify the new assessments. The board had arrived at its assessments by adding to the amount of the debt, the market quotations of the shares on April 1, 1900 (the statutory assessment date for the year in question), and without equalizing the assessments to correspond to the level upon which corporations and property generally were assessed, *i.e.*, at 70 per cent. The assessments were, therefore, excessive to this extent. But the Federal court was not content merely to reduce the assessments by 30 per cent. Instead, it first criticized the use of stock-market quotations for a single day, although the utilities had offered no evidence that a lower assessment would have resulted from the use of an average of market quotations. Then it declared the new assessments invalid for the queer reason that they represented, not the "independent judgment" of the state board, but rather the mechanical application of the stock-and-bond rule. Finally it recomputed the corporate-excess valuations by capitalizing net earnings for a single year; and it enjoined the collection of taxes on the board's assessments, provided the utilities should pay the taxes on the valuations computed by the court. Some of these valuations involved a reduction of much more than 30 per cent.

Following the apparent logic of its capitalized-earnings method, the court also held that a corporation which showed an operating deficit for the year in question was not subject to a corporate-excess assessment. This was, in effect, contrary to the holding of the United States Supreme Court in the *State Railroad Tax Cases*,[133] already discussed in the section on the Illinois railroad tax assessments.

As to the application of the capitalized-earnings method the Federal court adopted the following procedure:

1. In its determinaton of capitalizable net income, it allowed a deduction for the depreciation and maintenance, but not the extension, of tangible property (set, in the case of a streetcar company, at 6 per cent of the "current value of cars, track, and machinery").

2. In the determination of net income it also deducted taxes during the year in question, including an allowance for the very tax in controversy.[134]

[133] 92 U.S. 575 at 606 (1876).

[134] The opinion does not explain how the court solved the problem of deducting the very tax in controversy. But see Chap. XII, at pp. 257–258, for a theoretical

3. It accepted the net income for the single year as of which the tax was levied,[135] stating that this year did not appear to be exceptional in its record of earnings.
4. It accepted a 6 per cent capitalization rate.

In no subsequently reported cases have the methods of valuation under the Illinois capital-stock tax been reviewed by the Federal courts. But the Illinois Supreme Court, without referring to the two Federal opinions, has continued to approve of the stock-and-bond method as embodied in Rule Eleven, and has admonished the board to adhere to this rule.

The newly constituted board, however, seems now to be favoring a composite method of valuation, under which "earning value," no less than current stock and bond prices, shall be given weight. This, at least, is the tenor of its most recently published annual report.[136] And in 1933, it issued a revised form of tax return, to be filed by the taxpayer, which bears a striking resemblance to the form that was used by the Federal Treasury under the earlier Federal capital-stock tax. Schedule A of this return calls for a report of net earnings; Schedules B and C, for the market prices of the shares and the "amount" of the indebtedness; and Schedule D, for a condensed balance sheet.[137] How the board has actually computed its assessments during the pending business depression is a question on which we have no information. But, for reasons stated in the concluding section of this chapter, we deem the adoption of a "composite" test to be regrettable.

The Exclusion of Indebtedness Incurred for Current Operating Expenses.

While the general validity of the stock-and-bond method of valuation has been affirmed repeatedly by the state courts, most of the nicer points of valuation theory raised by the detailed application of this method have not been passed upon. The period of time over which stock and bond prices should be averaged; the type of average that may be used in order to express the typical market price; the extent to

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discussion of this problem. See also *supra*, p. 495; *infra* pp. 599–600, 606–607, 611.

[135] The state board computes its tax during the middle of the year for which the tax is levied.

[136] Ill. Tax Comm., 15th Ann. Rep. for Assessment Year 1933, especially pp. 211, 220, 224–226. The report says on p. 211: "The earning power of property is an important element in the valuation of property. [Citing Illinois and U.S. Supreme Court cases not dealing with the Illinois capital-stock tax.] . . . The above cases apply to property in general. The requirement that income be considered is even stronger in the case of the capital stock tax" [citing the Illinois Federal case already discussed in the text].

[137] Ill. Tax Comm., 15th Ann. Rep. for Assessment Year 1933, pp. 224–226.

which market prices may be discounted because of speculative activities or because of a temporary bear or bull market; the determination of the "fair cash value" of outstanding securities that have no established market value—these and other similar questions have been given no definite answers in the reported opinions. No doubt the reason why they have gone unanswered is that the courts have declined to substitute their judgment on questions of detail for that of the assessors and have therefore upheld the challenged assessments unless they were clearly unreasonable.

One point, however, has been definitely settled—indeed it has never been challenged to our knowledge. In the computation of the amount or value of the corporate indebtedness, under Rule Eleven, no account is to be taken of the "indebtedness for current expenses, excluding from such expenses the amount paid for the purchase or improvement of property." As the statute expressly excludes this type of debt from the information required to be filed by the taxpayer, we are not disposed to quarrel with the exclusion on grounds of statutory interpretation. But with the implication of the statute that, as a matter of appraisal theory, current debt should be ignored if it is incurred for operating expenses rather than for capital account, we take strong exception, for reasons discussed in an earlier chapter.[138] The purpose for which a debt was incurred has no proper bearing on the inclusion of the value of this debt under the stock-and-bond method of enterprise valuation. Any debt is to be included, not because it represents a capital investment, but rather because it constitutes a valuable legal interest in the entire enterprise. The mere fact that the debt may have been incurred to pay operating expenses, or even to pay a bribe to a politician, does not render it any the less a claim against the corporate enterprise, so long as the debt is concededly enforceable. Indeed, if *current* indebtedness is excluded when it was not incurred for capital account, there is no good reason why *bonded* debt similarly incurred should not also be excluded—indeed, no reason why watered stock or stock issued to pay operating expenses should not also be ignored. Yet, neither the statute law nor the courts have suggested these other exclusions. A queer but persistent psychological fallacy, associated with the well-recognized failure of accounting novices to distinguish clearly between asset items and liability items, probably explains this

[138] Chap. XII, pp. 246–247. Contrast the New Jersey railroad tax statute calling upon the taxpayer to furnish information on *all* indebtedness; and West Shore R.R. v. State Board of Assessors, 82 N.J.L. 37, 81 Atl. 351 (Sup. Ct., 1911), *aff'd on opinion below*, 84 N.J.L. 768 85 Atl. 826 (E. & A., 1913), discussed *supra* p. 542.

tendency of assessors and courts to assume that, under the stock-and-bond method of valuation, current debts should be ignored even though funded debts are included.

Deduction of the Assessed Value of the Tangibles, the Value of Extra-state Tangibles, and the Value of Tax-exempt Property.

Since the Illinois capital-stock tax is a "corporate-excess tax," the law requires that the assessment shall be based, not on the gross value of the whole enterprise, but on such portion of that value, if any, as exceeds the *assessed* value of the tangibles. The question might be raised whether assessed values are to be used merely as presumptive measures of "true value," subject to disproof by any party that may challenge them, or whether they are to be accepted on their own merits as a means of coordinating the local property tax with the corporate-excess tax.[139]

The latter conclusion has been drawn, and properly drawn, by the Illinois courts. In *Pacific Hotel Co. v. Lieb*,[140] the state Supreme Court declared that the capital-stock tax was designed, not merely to catch the intangible property of a corporation, but also to catch any tangible values that may have escaped taxation under the local property tax, either because of failure to appear on the tax rolls or because of underassessment. This pronouncement of the court, however, is true only with qualifications. Under Rule Eleven, the stock-and-bond value of the enterprise is "equalized" so as to make it correspond to the relative degree of underassessment prevailing with respect to property generally in the state; and it is from this equalized value that the assessed value of the tangibles is deducted. Because of this adjustment, the corporate-excess tax catches tangible values uncaught by the local property tax *only* when the taxpayer's tangible properties completely escape assessment or when they are assessed at a level lower than the level of equalization used by the state board. But the precise equalization methods used in Illinois are not made clear by the rules of the board or by the opinions of the courts, and we shall not attempt to analyze them.[141]

The decisions of the United States Supreme Court leave no doubt that the value of the corporate tangible property located outside of

[139] Frequently, where the law calls for the use of "true" or "actual" value, the assessed value is used as its presumptive measure, subject to disproof. See West Shore R.R. v. State Board of Assessors, *supra* note 138.

[140] 83 Ill. 602 at 610 (1876). Accord: Chicago, Burlington & Quincy R.R. v. Siders, 88 Ill. 320 at 326 (1877).

[141] For a discussion of equalization, see Hodes, "Illinois Capital Stock Tax," 28 *Ill. L. Rev.* 332 at 342 *et seq.* (1933).

Illinois must be deducted from the stock-and-bond value in arriving at a corporate-excess assessment.[142] Indeed, the Illinois attorney-general has so ruled.[143] But the issue has never been raised in the Illinois courts, presumably because the board has always made allowances for such property, as is illustrated in the case of *People ex rel. Little v. St. Louis Electric Bridge Co.*,[144] where the state board deducted the *assessed* value of the extrastate property. The taxpayer in that case did not dispute the use of assessed value, although he succeeded in overthrowing the assessment on other grounds.

However, after the value of the tangible property inside and outside Illinois has been deducted, the full amount of the remaining excess may be taxed in Illinois, not merely an allocated portion of it determined by the relative amount of property and business in Illinois as compared with the total amount of the property and business of the corporation.[145] The Illinois Supreme Court has so held,[146] even though the taxpayer was incorporated not only in Illinois but also in another state; and a decision of the United States Supreme Court involving the North Dakota corporate-excess tax suggests that this holding by the state court does not violate the Federal Constitution.[147]

Property exempt from taxation by Federal or state law, such as United States government bonds or shares in Illinois corporations, has been declared by the state attorney-general to be deductible from stock-and-bond value.[148] This ruling is eminently sound.

Effect of the Corporate-excess Tax upon the Methods of Assessing Tangibles.

With perhaps one exception, the coexistence of the corporate-excess tax has not led the courts to place any special limitations upon

[142] Delaware, Lackawanna & Western R.R. v. Pennsylvania, 198 U.S. 341 (1905).

[143] Ops. Ill. Atty. Gen. (Otto Kerner, 1933), p. 23, no. 7.

[144] 290 Ill. 307 at 312, 125 N.E. 280 at 281 (1919).

[145] In the return to be filled in by the taxpayer, as revised in 1933, the segregation of such assets and liabilities as pertain to Illinois is provided for, thus implying allocation. Ill. Tax Comm., 15th Ann. Rep. for Assessment Year 1933, pp. 224–226.

[146] Keokuk & Hamilton Bridge v. People, 161 Ill. 132 and 514, 43 N.E. 691, 44 N.E. 206 (1896), *writ of error dismissed*, 173 U.S. 702 (1899); 167 Ill. 15, 47 N.E. 313 (1897), *aff'd*, 175 U.S. 626 (1900) (on ground that the Federal question had not been raised in the state courts).

[147] Cream of Wheat Co. v. County of Grand Forks, 253 U.S. 325 (1920) ("due process"). In this case the corporation was not multi-corporate.

[148] Ill. Atty. Gen. Report & Ops. (Oscar E. Carlstrom, 1926), p. 37, no. 421. *Cf.* Oak Ridge Cemetery Corp. v. Tax Commission, 299 Ill. 430, 132 N.E. 553 (1921).

the permissible methods of valuing corporate tangible property for local assessment. Thus, in testing for overvaluation of tangible property, the courts have "considered" original cost,[149] replacement cost, and earnings. Stock and bond values seem not to have been used by the courts as a test. But the courts have clearly stated, contrary to the New York rule in the railroad tax assessments, that even *tangible* property may be assessed at more than cost, original or replacement, if the excess valuation is justified by earning power.[150] The danger that such an assessment would result in double taxation of the "corporate excess" is avoided by the rule under the capital-stock tax, whereby the *assessed* values of the tangibles are deducted from the gross enterprise values.

Summary.

Although the state board has often in practice made a hocus-pocus of its corporate-excess assessments, the official rules of valuation under this tax, as adopted by the board and supported by the state courts, are relatively clear, logical, and simple. One finds no such confusion of value concepts as are to be found, say, in the New York railroad real-estate tax cases, or in the New Jersey railroad tax cases. The following points are of special interest to the student of legal appraisal: (*a*) the consistent adherence by the state courts to the stock-and-bond method of enterprise valuation; (*b*) the initial use of the criterion of market value or "fair cash value" of the indebtedness, followed by the fallacious change to the criterion of face value; (*c*) the decision of a Federal court slighting the stock-and-bond method and using the capitalized-earnings method to test the validity of challenged assessments; (*d*) the exclusion, apparently required by the implications of the statute, of the current indebtedness incurred for operating expenses—an exclusion based upon a fallacy in appraisal theory; and (*e*) the deduc-

[149] But *cf.* Chicago & North Western Ry. v. Board of Supervisors of Boone County, 44 Ill. 240 at 245–246 (1867) (jury trial).

[150] See People ex rel. Little v. St. Louis Electric Bridge, 290 Ill. 307, 125 N.E. 280 (1919); People ex rel. Little v. St. Louis Merchants Bridge, 291 Ill. 95, 125 N.E. 752 (1919); Keokuk and Hamilton Bridge v. People, 161 Ill. 514, 44 N.E. 206 (1896); Sanitary District v. Gifford, 257 Ill. 424, 100 N.E. 953 (1913); Sanitary District v. Young, 285 Ill. 351, especially at 360–361, 120 N.E. 818, especially at 821 (1918); People ex rel. Wangelin v. St. Louis Bridge Co., 357 Ill. 245, 191 N.E. 300 (1934); People ex rel. McDonough v. Chicago Union Lime Works, 361 Ill. 304, 198 N.E. 1 (1935). Joel Moore notes a tendency for the tangible-property assessments to climb toward the valuations used to compute corporate-excess assessments: University of Illinois, *Studies in the Social Sciences,* Vol. II (1913), p. 99; see National Industrial Conference Board, *State and Local Taxation of Business Corporations,* (New York, 1931), p. 115.

tion of the tangibles at their assessed value rather than at their estimated actual value—a rule expressly designed to catch any tangible values that improperly escape local assessments.

VI. THE FEDERAL CAPITAL-STOCK TAX OF 1916 TO 1926[151]

Although abandoned in 1926 and later followed by a quite different tax of the same name,[152] the Federal capital-stock tax of 1916[153] has had a history important enough to justify its review in a study of taxes based on enterprise value. Indeed, the enactment of this tax imposed upon the Treasury the most formidable task of wholesale enterprise valuation ever faced in the history of our country—the task of reappraising annually the stock equities in about 300,000 business corporations. The magnitude of this assignment may be appreciated when one considers that a litigated valuation of a single large corporate property may entail an expenditure of several million dollars and may keep a staff of experts busy for several years.[154]

The Statute.

Faced, during the World War, with the necessity of increasing the Federal revenues, Congress enacted two taxes supplementary to the corporate-income tax: the excess-profits and war-profits tax,[155] and the capital-stock tax. Of these the former is of much greater interest to economists, since it involved a theory of taxation that is likely to

[151] See Robert H. Montgomery, *Income Tax Procedure*, 1918, 1920, 1922–1925 (New York); *Excess Profits Tax Procedure*, 1921 (New York); *Excess Profits, Estate, Gift and Capital Stock Tax Procedure*, 1926 (New York).

[152] See *infra* p. 594.

[153] 39 U.S. Stat., Pt. 1, p. 789 (64th Cong., 1st Sess., C. 463, Sec. 407 [1916]); 40 U.S. Stat., Pt. 1, p. 1126 (65th Cong., 3d Sess., C. 18, Sec. 1000 [1919]). The statute was reenacted in 1921 and 1924 without material change. Repealed: 44 U.S. Stat., pp. 125–126 (69th Cong., 1st Sess., C. 27, Sec. 1200 [1926]).

[154] An appraisal of its properties made several years ago by the New York Edison Company for purposes of rate regulation is said to have cost about $5,000,000. The Interstate Commerce Commission commenced its appraisal of the railways in 1913 and not until 1932 finished its primary appraisals of the 1,685 steam railroads listed as existing on Mar. 1, 1913. I. L. Sharfman, *Interstate Commerce Commission*, Pt. III A (New York, 1935), p. 39. Up to June, 1933, the commission's outlays for this work were $46,000,000 and the outlays by the railroads themselves were much greater.

Under the capital-stock tax, a staff of approximately 115 home-office employees and 15 field workers was assigned to the task. See the annual reports of the Commissioner of Internal Revenue. The average cost to the taxpayer of preparing and filing each return has been estimated at about $50. Montgomery, *Excess Profits* (etc.) *Tax Procedure*, 1926, pp. 741–742.

[155] 40 U.S. Stat., Pt. 1, p. 302 (65th Cong. 1st Sess., C. 63, Secs., 200–214 [1917]). The tax remained in effect until Dec. 31, 1921.

find much favor in the future. But since its determination of excess profits was based on actual capital investment,[156] not on current capital *values*, it gave rise only incidentally to problems of appraisal and will therefore be ignored in this treatise.[157]

In order to circumvent the constitutional limitations on Federal direct taxation, Congress called the capital-stock tax "a special excise with respect to carrying on or doing business." As applied to a domestic corporation, the tax base was set at the "fair average value of its capital stock for the preceding year ending June 30." As applied to a foreign corporation, the provisions were the same, except that the tax was here measured by "the average amount of capital employed in the transaction of its business in the United States during the preceding year ending June 30." The problem of determining the capital of foreign corporations employed in the United States will not be discussed.[158] Under the earlier act, the rate was 50 cents per $1,000 of capital stock, and the capital exemption was $99,000. Under the act of 1919 and thereafter, the rate was raised to $1 per $1,000, and the exemption was reduced to $5,000. This reduction increased the number of reporting domestic corporations from 60,000 to 325,000 per year.[159]

As Montgomery points out,[160] the rates of taxation were so moderate that most taxpayers did not find it worth while to contest their assessments; and this fact doubtless accounts for the comparatively small costs of administration. Why Congress saw fit to make use of this new device in raising revenues, rather than merely to raise the rates of the corporate-income tax, is a question to which we have seen no satisfactory answer. Presumably there was a desire, first, to levy taxes on companies with little or no current net income, and second, to increase the total levies on corporations while avoiding the odium of an increase in any one tax rate.

Meaning of "Capital Stock."

Before the problems of appraisal could be intelligently faced, two statutory terms required interpretation: "capital stock," and "fair average value" of this stock. As noted by the Supreme Court,[161] the

[156] See La Belle Iron Works v. U.S., 256 U.S. 377 (1921).

[157] For treatment of the tax, see Montgomery, *Income Tax Procedure*, 1918, 1922–1925; *Excess Profits Tax Procedure*, 1920, 1921; *Excess Profits* (etc.) *Tax Procedure*, 1926.

[158] See Montgomery. No litigated case involving this problem under the capital-stock tax has come to our attention.

[159] See the annual reports of the Commissioner of Internal Revenue.

[160] *Excess Profits* (etc.) *Tax Procedure*, 1926, p. 695.

[161] Ray Consolidated Copper Co. v. U.S., 268 U.S. 373 at 375 (1925), discussed *infra* p. 590.

first of these terms has no established meaning in law or economics. Yet the act did not define it, nor did it give any clue to a definition save for the following sentence: "In estimating the value of the capital stock the surplus and undivided profits shall be included."

With this somewhat misleading clue, and doubtless in the light of the Congressional hearings and debates,[162] the Treasury was compelled to seek its own definition of "capital stock." First, it concluded that the term referred merely to the stock equity in the company, and not to the gross value of the enterprise including such a value as was offset by debts. This was a sound interpretation under the act but was at variance with the use of the same term under the capital-stock taxes of Illinois[163] and of certain other states. Secondly, the Treasury distinguished between the capital stock of a company, and the outstanding shares held by individual stockholders. This distinction is recognized under most state capital-stock taxes, although it is not observed in Massachusetts and in some other states.[164] Thirdly, the Treasury held that capital stock did not refer merely to the aggregate of the specific assets, minus liabilities, as listed on a balance sheet. Yet the statutory sentence requiring the "inclusion" (not merely the "consideration") of "surplus and undivided profits" suggests accounting concepts of assets and of asset values.

These delimitations of the concept of capital stock led to the identification of the term with the entire undivided stock equity in the company—with the "potentiality" of the corporation as a source of profits available for shareholders. Save for the deduction of the debts, "capital stock" was treated as a synonym for the entire enterprise or "going concern."

Both in its negative and in its positive interpretations of capital stock, the Treasury was soon upheld by the courts. The noninclusion of the debts seems to have been taken for granted without litigation. The distinction between the capital stock and the outstanding shares was supported first by the lower Federal courts and then by the Supreme Court, as was the further distinction between the capital stock and the corporate assets.[165] The identification of capital stock with the enterprise as a source of future profits available for stockholders was upheld by the Supreme Court in the leading case of *Ray Consoli-*

[162] See Cong. Rec., Vol. 53, Pt. 13, p. 14118 (64th Cong., 1st Sess., Sept. 7, 1916, House).

[163] See *infra* pp. 562 *et seq.*

[164] See Commonwealth v. Cary Improvement Co., 98 Mass. 19 (1867); National Bank of Commerce v. City of New Bedford, 155 Mass. 313, 29 N.E. 532 (1892), 175 Mass. 257, 56 N.E. 288 (1900).

[165] See the cases discussed *infra* pp. 589–594.

dated Copper Co. v. United States,[166] where Justice Brandeis cited with approval an earlier opinion to the same effect by the Circuit Court of Appeals, in *Central Union Trust Co. v. Edwards.*[167] In a later section we discuss both of these cases and quote from the opinion by Justice Brandeis.

Meaning of "Value" of the Capital Stock.

The interpretation of capital stock to mean aggregate stock equity still left open the question, What was meant by the "fair average value" of this equity? As to the complication introduced by the statutory use of the word "average," something will be said in a later section. At present we may consider the more fundamental question as to the use of the word "value"[168] itself.

For reasons discussed at length in Chap. XII, the very definition of the "*value*" of an enterprise, and not merely the technique of estimating it in quantitative terms, presents serious difficulties. No doubt these difficulties account for the absence of any formal definition in the Treasury regulations or in the opinions of the courts. Implicit, however, in the official rulings and comments on *methods* of appraisal was the value concept of the professional appraiser as distinguished from the market-value concept of the economist—the concept of "justified selling price" distinguished from the price at which the total equity in the enterprise might actually have been sold during the year in question. The reader is referred to our earlier discussions of this vague, but often indispensable, definition of value.[169] In a later chapter we shall note its use even in the valuation of individual shareholdings under the Federal income tax.[170] But as applied to an entire corporate enterprise, no alternative concept of value would have been acceptable save with respect to those relatively few enterprises that are actually salable, in their entirety, at a price that can be approximately predetermined.

The Treasury's Methods of Valuation: First Period, 1916 to 1918.

Unlike the situation under the local real-property taxes, the taxpayer was required to submit for the consideration of the Treasury its own valuation of its capital stock, calculated according to the instruc-

[166] 268 U.S. 373 (1925).

[167] 287 Fed. 324 (C.C.A. 2d, 1923).

[168] Apparently the qualifying word "fair" in the phrase "fair average value" played no significant practical role. A dictum by Judge Hough declared that "fair" value was the exact equivalent of "actual" value. Central Union Trust Co. v. Edwards, 287 Fed. 324 at 328 (C.C.A. 2d, 1923).

[169] *Supra* pp. 24–29.

[170] Chap. XXIX.

tions printed on the return and according to the Treasury regulations. This valuation in no way bound the Department; but the proportionate number of cases in which the Department disregarded the taxpayer's valuation is a matter on which we have no information.

The year 1918 marks a division between two quite different policies of valuation as announced by the Treasury. During the earlier and shorter period, the capital stock of corporations whose shares had been subject to fairly active trading was to be valued by exclusive reference to the market quotations of these shares;[171] and even with respect to corporations whose shares had no established market prices, the value of the capital stock was to be derived from a hypothetical market value per share, estimated largely by reference to book values and to capitalized earnings. During the second period, the emphasis on share quotations was abandoned in favor of a valuation based chiefly on consideration of three different kinds of data: book values, share quotations, and capitalized earnings. In the present section attention will be given to the earlier policy.

In 1916, at the very inauguration of the tax, the Treasury issued its Regulations 38,[172] defining the methods of valuation to be followed. Three situations or "cases" were distinguished.

Case I. Where the corporate shares were listed on an exchange, the value of the capital stock was to be based on the average market price per share during the preceding year. This average was to be set at the arithmetic mean of the highest bid prices on the last business day of each month. But the taxpayer was given the option of averaging the highest bid prices for each day of the year.

Case II. Where the shares were not listed, but where a "sufficient" number of private sales had taken place, the "average price at which

[171] Under Regulations 38, the Treasury made the absurd ruling that, in the valuation of capital stock by reference to share quotations, the average market price per share should be applied not only to shares in the hands of the public but also to treasury stock. Sharp criticism from taxpayers and tax-service writers caused it to abandon this position in Revised Regulations 38 of 1918. But Regulations 50 of 1919 and Revised Regulations 50 of 1920 provided that treasury shares pledged as security for a debt were to be included as outstanding shares, to be multiplied by the average market price per share—an obviously fallacious rule. The regulations issued after 1920 were silent on the subject of treasury shares. No judicial pronouncement has come to our attention.

[172] T.D. Int. Rev., Vol. 18, p. 197, No. 2383, Oct. 19, 1916. Later Treasury rulings bearing upon the methods of valuation under Regulations 38 are: same, p. 259, No. 2417, Dec. 16, 1916; same, p. 272, No. 2423, Dec. 30, 1916; Vol. 19, p. 127, No. 2503, June 25, 1917. For a good summary of the valuation methods used under Regulations 38, see Commissioner of Internal Revenue, Ann. Rep. for Year Ended June 30, 1917, at pp. 145–147.

sales were made" during the year was to be the "determining factor." "Sufficient" was not defined. A later Treasury decision distinguished between "average price at which sales were made" and "average selling price." The former phrase, which set the standard of valuation, was held to refer to an average that was not weighted by the number of shares sold in each transaction. Thus, if a sale of ten shares had been reported at $100, and if a sale of one thousand shares had been reported at $70, the average was to be taken at $85 rather than at $70.29.

Case III. Where the shares had no established market price, the value of the capital stock was to be estimated by reference to the amount of surplus and undivided profits, the nature of the business, the estimated earning power of the company, the average dividends per share paid during the preceding 5 years, and the average profits per share earned during the same period. More definitely, collectors were at first instructed, in effect, to use book value (adjusted to take care of any fictitious valuations), or "estimated earning capacity" as indicated by the average profits during the preceding 5 years, whichever was higher.

In a new set of instructions issued several months later, collectors were simply told that the value of the stock might be estimated from earning capacity. But, it was added, corporations that have no regular earnings, and corporations that have earned no profits in the past 5 years or have been engaged in business only for 1 or 2 years, cannot very well estimate the value of the stock from their earning capacity, and they may therefore file, with the return, a detailed statement of assets and liabilities and may estimate the fair average value of the stock from the book value.

In the earliest published rulings on the capital-stock tax, "estimated earning capacity" was defined as the prospective earnings for the next following year. But this restrictive definition never reappeared, and in its stead was substituted the statement that estimated earning capacity was "indicated" by the average profits earned during the preceding 5 years. With respect to the capitalization rate, an early Treasury ruling stated that the rate should be determined by the consideration of a reasonable return on invested capital, and by reference to the current market quotations of shares of companies engaged in a similar type of business.

In the middle of 1917, the Department issued a table of typical capitalization rates for various types of enterprise, prefacing the table with this statement: "It has been found upon examination of the returns of net income [presumably for income-tax purposes] of a large number of different classes of corporations listed on an exchange that

they earn approximately the following rates in order to make their stock worth par." The rates were set at 6 per cent for banking corporations east of the Mississippi River; at 8 per cent for banking corporations west of the Mississippi and for railroads, light-and-power companies, electric railways, and other public utilities; at 10 per cent for mercantile, industrial, mining, and oil-refining companies; and at 15 per cent for contracting and construction companies and for oil-producing companies. But these rates were not made mandatory; they merely reflected the general views of the Treasury as to the types of rates that would be deemed acceptable. In more recent years, most of these rates of capitalization were higher than those reflected by the actual sale prices of shares or of entire enterprises.[173] At the time when they were issued, however, they may well have been fairly typical.

During this early period, when the Treasury preferred to rely on stock-market quotations whenever feasible, the attempt was often made to value the capital stock of subsidiary corporations whose shares were closely held by a parent company, by assigning to each subsidiary a share of the "fair average value" of the capital stock of the parent company itself. In one specific case,[174] the Department advised a collector to impute to the capital stock of the subsidiary such a portion of the value of the capital stock of the parent company[175] as was measured by the ratio of the net profits returned to the parent by the subsidiary, to the total net profits reported by the parent. Upon objection by the collector, the Department changed its allocation formula to the proportion that the net profits of the subsidiary bore to the net profits earned by all the subsidiaries plus the net profits earned by the parent from sources other than its subsidiaries. This change was made in order to take care of a subsidiary that had earned a large profit which it applied to its own surplus instead of disbursing it to the parent company in the form of dividends.

In another case,[176] unit-share certificates had been issued, carrying in the same instrument one share of stock in a national bank and one share of stock in an affiliated trust company. Here the Department approved a suggestion that, in the valuation of the capital stock of each corporation, the market value of the composite share certificate be

[173] See our discussion of capitalization rates, *supra* pp. 259–264.

[174] T.D. Int. Rev., Vol. 19, p. 103, No. 2493, May 22, 1917; same, p. 140, No. 2509, July 7, 1917.

[175] In this section, we use the term "parent company" without regard to the technical distinctions between a "parent" and a "holding" company.

[176] T.D. Int. Rev., Vol. 18, p. 277, No. 2426, Dec. 29, 1916. See also Commissioner of Internal Revenue, Ann. Rep. for Year Ended June 30, 1917, p. 147.

apportioned between the two companies by reference to the relative paid-in capital, surplus, and undivided profits of each company during the preceding year.

The Treasury's Methods of Valuation: Second Period, 1918 to 1926.

Despite the obvious administrative charm of valuations based on average stock-market quotations, the Department, in 1918, abandoned this procedure in favor of a much more complicated policy based largely on a consideration of three alternative appraisals. In his report for 1919,[177] the commissioner commented as follows on this change:

> The early regulations touching valuations have been radically elaborated and modified until under present approved methods it has become necessary to individualize each case, considering all elements and factors which throw light on values and harmonizing them as far as possible in the ultimate values found.

"Individualize each case," indeed! The kind of individualizing that is possible under an administration whereby each staff employee has to pass upon eight or ten capital-stock values per day, can well be imagined. As to the motives that led to the "new era" of appraisal we have no information. Certainly the compulsion of judicial decision could not have been operative, since no pertinent decisions under the capital-stock tax had yet been handed down. One consideration, however was probably potent. Under the earlier regime, the absence of established market prices for the shares of small or closely held corporations led to a valuation of *these* enterprises at book values, or by reference to reported earnings. In consequence, corporations of this type were assessed relatively more heavily than corporations whose stocks had an established market price.[178] This situation was obviously unfair. But it could have been corrected by a reduction in the assessments against the former corporations rather than by an increase in the assessments against corporations with active stock issues.

In any event, the change in policy was far reaching. It was embodied in a revised edition of Regulations 38,[179] and in a revised form of return (Form 707)[180] required of taxpayers. Many revisions were subsequently made, but none of them was fundamental.

[177] At p. 41.

[178] Montgomery, *Income Tax Procedure*, 1918, p. 650.

[179] T.D. Int. Rev., Vol. 20, p. 459, No. 2750, Aug. 9, 1918.

[180] A copy of Form 707 as revised in 1918 is printed in Revised Regulations 38. Copies of Form 707 for the taxable years 1924 to 1926 will be found in Commerce Clearing House (C.C.H.) Federal War Taxes (1923–1926). Excerpts from the instructions printed on Form 707 for each of the years during which the tax existed will be found in Montgomery's books.

The Three Valuations as Required by Form 707.

Form 707, as amended in 1918, required the taxpayer to furnish three exhibits, each of which was to disclose a possible valuation of the capital stock.

Exhibit A called for a condensed balance sheet, showing assets and liabilities as they appeared on the taxpayer's books but with an additional column for an adjusted "fair value" of any asset or liability the value of which was deemed to be misstated by the book entry. Material adjustments were to be explained. The adjusted net asset value (*i.e.*, adjusted asset value minus adjusted value of the liabilities) gave a value of the capital stock as reflected by this exhibit.

Exhibit B called for a valuation of the capital stock based on the market prices of outstanding shares. If the shares were listed, the taxpayer was to compute an average market price per share by adding the means of the highest and lowest bid prices for each month, and by dividing the sum by twelve—a departure from the prior rule requiring that merely the highest bid price for each month be taken. It was optional with the taxpayer, however, to take the average of the means of the highest and lowest bid price for each day of the year. Although the approximate number of shares traded in during the year was to be stated in the return, the number of shares sold each month or day was not to affect the computation of the average market price. If the stock was not listed, but if private sales had been made at prices known to the officers of the company, these prices were to be reported, together with the number of shares sold and the conditions of the sale. However, sales to employees or sales to directors for qualifying purposes were to be disregarded, as were sales restricted as to resale or sales at prices otherwise specially influenced by the terms of the trade. The form contained no instructions as to the method of computing from these data the average market price of unlisted shares.

Exhibit C called for a valuation of the capital stock by a capitalization of net income after the deduction of interest on debt. This net income was first to be stated as reported for the income tax or the excess-profits tax. But an "adjusted income" was then to be calculated, which should represent "the actual operating income to be used for capitalizing." This adjustment was designed to include in the capitalized income receipts of interest on government securities, and receipts of dividends from other corporations; and it also was designed to deduct income and excess-profits taxes for the year in question. The above reports of income were to be made for each of the five preceding years, and the resulting average annual adjusted income was to be capitalized at a percentage "that fairly represents,

under the conditions obtaining in the trade and in the locality, what representative enterprises must earn in order to maintain their stock at par."

In addition to furnishing these three exhibits, manufacturing and trading corporations were required to report their annual gross sales for the preceding 5 years.

Finally, Form 707 provided a column entitled "Computation of the Tax," in which the taxpayer was to state its estimate of the "fair value of total capital stock for fiscal-year determined by Exhibit. . . . " This last phrase would imply that the capital stock must be valued exactly at the amount indicated by *one* of the three exhibits, and not at some compromise figure. Indeed, the instructions accompanying Form 707 in its 1918 version stated that, ample provisions having been made for adjustments in Exhibits A and C, "the taxpayer will report as the fair value of its capital stock . . . the amount reflected by the exhibit showing the greatest value." It added the qualification, however, that "corporations materially affected by extraordinary conditions" might report as the "fair value" of their capital stock, "the amount reflected by the exhibit which in their opinion more nearly shows the required value." A year or so later, this instruction was modified so as to read that if the value reflected by any of the three exhibits was greater than the valuation returned, the taxpayer should present a comprehensive statement showing any "extraordinary conditions" relied upon to support its claim. Thus the Treasury set up a *presumption* that the "fair value" of the capital stock was measured by whichever exhibit showed the highest value. Although any such presumption is quite unwarranted by good practice in commercial appraisal, it was sanctioned in fact, though not in form, by judicial decisions later to be reviewed.

Treasury Regulations under the New Policy of Valuation.

Form 707, as revised in 1918, was retained with minor changes until the capital-stock tax ended its career in 1926. But during this period the Treasury issued one set of regulations after another dealing with methods of appraisal—Revised Regulations 38 in 1918, Regulations 50 in 1919, Revised Regulations 50 in 1920, Regulations 64 in 1922, and Revised Regulations 64 in 1924. These various regulations were so indefinite that their provisions are hardly worth reviewing in detail.

All the regulations down to those of 1922 implied that the value of the capital stock is usually most reliably reflected by earnings but that, despite this fact, the Department would not ordinarily go *below*

book value (and, until 1920, also not below a value derived from the market price of the shares)! In 1922 the verbal emphasis on earnings disappeared, and Regulations 64, as well as *Revised* Regulations 64 (which made no change in the valuation provisions), resorted to question-begging phrasemaking, with references to "harmony" and to a "consideration of all elements." "Fair value" did *not* mean par value, or book value, or market value, or earning value. What, then, did it mean?

> The fair average value . . . shall be determined from a consideration of the data contained in the return as well as all elements and factors affecting values, which should be harmonized so far as possible in the ultimate fair value found. Fair value is required irrespective of the exhibit used or the method employed in its determination.

Yet, from the annual reports of the Commissioner of Internal Revenue it appears that only a few thousand cases were investigated by reference to any data other than those filed in the taxpayer's return or reported in financial manuals. As to the great bulk of the 300,000-odd cases per year, a mere routine audit, checked by some rule-of-thumb choice as to the governing exhibit, must have sufficed. If any conclusion as to methods of valuation actually adopted can be drawn from Regulations 64, original and revised, it is that the Department ordinarily belittled Exhibit B, with its showing of share quotations, and adopted instead the value shown by Exhibit A or C, whichever was higher.[181] This conclusion is supported by the few valuation cases which appear in the judicial reports.

Implications of Statutory Word "Average."

Before turning to the judicial rulings on valuation, we may first note a few special points of dispute as to the interpretation of the act. One of these disputes concerned the statutory use of the word "average" in the provision measuring the tax upon each corporation by "the fair average value of its capital stock for the preceding year ending June 30."

The overt reference to an *average* value over a specified period of time is rare in tax legislation. Ordinarily, in ad valorem taxation, the assessment is supposedly based on the value of the property as of the precise assessment date, even though the value may have been quite different during the remainder of the year as of which the tax is levied, and even though the property itself was nonexistent or outside

[181] However, the instruction on Form 707, clearly indicating that the highest of the three exhibits should be used, remained unchanged.

the jurisdiction on every other day.[182] To be sure, a range of market prices prevailing over a considerable period of time is often taken into account by administrative practice or even by statutory mandate—but only, ostensibly, as a means of estimating the "fair value" of the property on the very day of valuation.

The peculiar phrasing of the capital-stock tax at once led to controversy. A literal interpretation would seem to require that consideration be given to *all* changes in the net value of the enterprise during the year preceding the tax—changes due to an increase or decrease in the amount of stock issued and outstanding, to charges or credits to surplus or undivided profits, or merely to revised prospects of future earnings. But the Treasury declined to go as far as this. Instead, it drew a distinction between an averaging of the *value* of the capital stock, which it expressed willingness to make, and an averaging of the capital stock itself, which it declined to make. The precise nature of this distinction was never made clear. But the Department seems to have held, in effect, that the tax should be based on whatever *amount* of capital stock was outstanding at the very end of the year in question; and that "average value" referred to an average of the value of *this* stock for that portion of the year during which it was outstanding.

The issue was most clearly drawn with respect to two situations: (*a*) that of a company which had increased or decreased its outstanding share capital during the year preceding the tax; and (*b*) that of a company which had been engaged in business during only a part of this year.

As to the first situation, the early regulations and instructions were not clear, although they were assumed by the private tax services to permit some sort of an averaging of the different amounts of shares and of net assets as reflected on the balance sheet. But Regulations 64, issued in 1922, expressly ruled out this kind of averaging. This new ruling was severely criticized by the commentators and was later abandoned as a result of a decision by Judge Bondy in *One Liberty Street Realty & Securities Corp. v. Bowers.*[183] The court here declared the above regulations invalid and held that, under the statute, the capital stock must be averaged. It declined, however, to lay down any specific method of averaging. Accordingly, the Department amended its regulations to provide that, if any "material" changes had occurred in the outstanding capital shares, then the average number of shares outstanding during the year was to be

[182] See Thomas M. Cooley, *Law of Taxation* (4th ed., 1924), Secs. 546, 1,062.
[183] 8 F. (2d) 278 (S.D.N.Y., 1925).

"given effect." Similar cognizance was to be taken of material changes in assets and liabilities. But the method by which the average was to be "given effect" was not stated.

As to the second situation, that of a company which had been engaged in business during only a part of the year, the Department consistently declined to abate the assessment. Here it was upheld by the Court of Claims,[184] in two decisions rendered after Judge Bondy's decision in *One Liberty Street.* The court took the position that, since the tax was based on the privilege of doing business *for the following year*, the "fair average value" of the capital stock during the preceding year was used merely as a convenient measure of the value of this privilege. Under this interpretation of the intent of the statute, the mere fact that the corporation had been doing business only during the latter part of the year was held immaterial. The Court of Claims distinguished its holding from that of Judge Bondy. Yet it is clear that the two rulings are based on inconsistent premises.

Allowable Deductions.

Since the capital-stock tax was called "a special excise tax with respect to carrying on or doing business," the question arose whether or not a deduction should be made for any part of the capital stock that was not connected with business operations. The statute itself provided for no such deductions. In December, 1916, the Treasury issued a ruling implying, though not expressly declaring, that the value of securities held for investment was to be deducted.[185] However, in 1918 and continuously thereafter, it repudiated this suggestion and stated in its regulations that if a corporation was doing any business, it was taxable on its entire capital stock even though most of this stock was not employed in the business. Exception was not even made for holdings of tax-exempt securities, such as government bonds, nor for the capital of domestic corporations invested outside the United States.

Court Decisions on Principles of Valuation.

No valuation cases were decided by the courts until 1922, after the capital-stock tax had passed the mid-point of its career. When these decisions came, they confirmed the Department in its general procedure, with two exceptions. But the student of legal precedents in other fields of appraisal should not attach too much importance to

[184] Alaska Consolidated Canneries v. U.S., 66 Ct. Cls. 713 (1929); Associated Furniture Corp. v. U.S., 44 F. (2d) 78 at 83 (Ct. Cls., 1930).

[185] T.D. Int. Rev., Vol. 18, p. 259, No. 2417, subd. 2, Dec. 16, 1916.

this fact. No doubt the very moderate rate of taxation, combined with the prodigious number of returns on which the administration was compelled to pass, predisposed the courts to uphold the government.

Central Union Trust Co. v. Edwards[186] was the first decided case involving valuation. Here the Department had valued the capital stock of a prosperous trust company at an amount equal to $575.97 per share as compared with a book value of $440 per share and with an average market price of $788.75 per share. The method of valuation used by the Department was not stated in the opinion,[187] and the taxpayer challenged the assessment on only one issue. It contended that, under the statute, the tax base was limited to the paid-in capital stock plus surplus and undivided profits—in short, to what is ordinarily called "book value." But the assessment was upheld by the District and Circuit courts. The latter court declared that "capital stock" here meant "the entire potentiality of the corporation to profit by the exercise of its corporate franchise." Earnings and market quotations of the shares might be "considered," no less than balance-sheet values.[188]

Ray Consolidated Copper Co. v. United States,[189] which went from the Court of Claims to the Supreme Court, is the leading case on the capital-stock tax and is still often cited in other valuation cases. The company's shares had been subject to almost daily trading on the New York Stock Exchange, and the volume of sales during the year in question amounted to about one-third of the total number of outstanding shares. Although the average market price of these shares

[186] 282 Fed. 1008 (S.D. N.Y., 1922), *aff'd*, 287 Fed. 324 (C.C.A. 2d, 1923), *appeal dismissed*, 266 U.S. 579 (1924).

[187] In his *Excess Profits* (etc.) *Tax Procedure*, 1926, p. 720, Montgomery indicates that the Department had at first valued the capital stock at the market prices of the shares; and that its revised assessment, which was contested in the reported case, was produced by an 8 per cent capitalization of average earnings for the preceding 4 years. Presumably this change from a share-quotation basis to a capitalized-earnings basis took place after the Department had adopted its "new policy" of valuation. We are not informed why the Department here used a 4-year average of earnings despite its usual practice of taking a 5-year average.

[188] In denying that the tax base was limited to paid-in capital plus surplus and undivided profits, the Circuit Court of Appeals relied on a similar denial as to the purport of the act made by Representative Kitchin, the committee member in charge of the bill. 53 Cong. Rec., Pt. 13, p. 14118 (64th Cong., 1st Sess., Sept. 7, 1916).

[189] 59 Ct. Cls. 686 (1924), *aff'd*, 268 U.S. 373 (1925). Compare the somewhat confusing dicta on the use of net-asset value as establishing capital-stock value in the earlier Supreme Court opinion in Hecht v. Malley, 265 U.S. 144 at 162–163 (1924).

(par $10) had been estimated at only $22 per share, the Department assessed the capital stock at the equivalent of about $35 per share—a value based on an appraisal of the corporate assets. This appraisal was derived from the value previously established by the taxpayer for its chief asset, a mine, as a "basis" for depletion under the income tax,[190] and from the values of its other assets and its liabilities as reported by it in its capital-stock tax return.

The question at issue was whether the fair value of the capital stock was set definitely by the market prices of the shares as established by bona fide sales on a large scale on the open market; aside from this point, the taxpayer did not challenge the assessment. In affirming the lower court, which had sustained the commissioner, the Supreme Court said:

> [Congress] declared that the tax should be measured by the "fair average value of its (the corporation's) capital stock." In so doing, it used a term which has no fixed meaning in taxing statutes and it gave no directions for ascertaining such value, except that in "estimating" value "the surplus and undivided profits shall be included."
>
> As the term "capital stock" has no fixed significance, it must be construed in a particular statute by reference to the context, the nature and purpose of the statute, its history and other aids to construction. We think that, as here used, it means the entire potentiality of the corporation to profit by the exercise of its corporate franchise. *Central Union Trust Co. v. Edwards*, 287 Fed. 324, 328. As the method to be pursued in ascertaining the value is not prescribed, we think that it was left to the sound judgment and discretion of the Commissioner, subject only to the obligation to take into consideration every relevant fact [citation].
>
> The capital stock of a corporation, its net assets, and its shares of stock are entirely different things [citation]. The value of one bears no fixed or necessary relation to the value of the other. The net fair value of the assets was clearly a relevant fact bearing upon the value of the capital stock. It does not appear that the Commissioner refused to consider the selling price of the shares or other factors. He may have given much consideration to the selling price of the shares, and have concluded that, under the conditions prevailing in the year 1920, the average price at which relatively small lots were sold on the Stock Exchange was not a fair indication of the value of the capital stock. We cannot say that he acted arbitrarily or abused his dis-

[190] Under the income tax, the company's basis for depletion had been set at $93,678,245, the "fair market value" of its wasting assets as of Mar. 1, 1913. In assessing the capital stock, the Department at first valued the ore resources at this amount minus an allowance of $13,318,384 for subsequent extractions. But during the litigation it reduced its valuation, for some unstated reason, to $32,282,993 and revised the assessment accordingly. On its capital-stock tax return the company had valued its mine at only $8,657,620.

cretion in concluding that "the fair value of the capital stock considered as a whole is not materially less than the net fair value of the assets."

Commenting on this case, Montgomery pointedly remarks:[191] "A fair inference from the decision as a whole is that the court was greatly influenced by the taxpayer's own statements of value used by it in claiming deductions for depletion. Taxpayers should realize that the Capital Stock Tax Division keeps in close touch with the claims advanced before the Income Tax Unit."

In the *Ray* case the commissioner was sustained in valuing the capital stock by reference to a valuation of the assets despite the much lower value indicated by prevailing share quotations. In *Park Falls Lumber Co. v. Burlingame*,[192] the commissioner was likewise sustained in using net "asset value" despite indications of deficient earning power. The company's shares had no established market value. But its books showed a paid-in capital of $3,450,000, surplus and undivided profits of $155,259, and an additional "unearned surplus" of $1,774,802 representing, for income-tax purposes, the amount by which the actual value of its stumpage land, as of Mar. 1, 1913, exceeded actual cost. While not denying that the sum of these several capital and surplus accounts, $5,380,061, reflected the "fair value" of its *assets* for the year in question, 1919–1920, the taxpayer asserted that its *capital stock* was worth only $3,450,000, since "due weight" should be given to deficient earning power. Indeed, since 1913 its business had been done at a net loss. But the court upheld the assessment, without discussing principles of valuation. It was content to note that all the evidence adduced in the trial had already been presented to the Department, had been considered by it (as shown by its correspondence with the taxpayer), and was insufficient to impeach the assessment.

Argonaut Consolidated Mining Co. v. Anderson,[193] like the *Ray* case, upheld the Department in adopting a valuation based on an appraisal

[191] *Excess Profits* (etc.) *Tax Procedure*, 1926, p. 716.

[192] 1 F. (2d) 855 (C.C.A. 7th, 1924).

[193] 52 F. (2d) 55 (C.C.A. 2d, 1931). See an earlier dictum by the same judge stating that the valuation of the capital stock "would ordinarily be reached by subtracting the liabilities from the assets." N.Y. Life Insurance Co. v. Bowers, 39 F. (2d) 556, at 558 (C.C.A. 2d, 1930). For other tax-valuation cases dealing with mines and other "wasting assets," see South Utah Mines & Smelters v. Beaver County, 262 U.S. 325 (1923); Union Sulphur Co. v. Reid, 271 Fed. 978 (W.D. La., 1920); People ex rel. McDonough v. Chicago Union Lime Works Co., 361 Ill. 304, 198 N.E. 1 (1935); Cumberland Pipe Line Co. v. Lewis, 17 F. (2nd) 167 (E.D. Ky., 1921); see also C. H. Baxter and R. D. Parks, *Mine Examination and Valuation* (Michigan, 1933) (contains a comprehensive bibliography).

of assets rather than a lower valuation based on stock-market prices. Here the taxpayer was a parent company, with almost no assets except a 51 per cent stock interest in the *X* Mining Company. The taxpayer's income from dividends was not stated in the opinion, nor was mention made of the market prices of its own shares. But the Department had based its valuation of the capital stock on an estimated value of the *X* company's shares, which in turn was based on a departmental appraisal of the mining properties. In challenging the asesssment, the taxpayer insisted that the value of the *X* company shares should have been calculated at their average sale prices on the San Francisco Stock Exchange. But the court upheld the Department on the authority of the *Ray* case, noting that the *X* company's shares had been subject to much less frequent trading than had the shares of the Ray Consolidated Copper Company. Judge Learned Hand, who wrote the opinion, also gave attention to the Department's method of appraising the mining property. The Department had appraised this property by the use of a special form of the capitalized-anticipated-income method, whereby an estimate is made of the tonnage underground and of the profits to be expected from extraction, and whereby the present value of this future income expectancy is calculated, with due allowance for ultimate exhaustion. Judge Hand noted that, for most of the taxable years in question, the Department's valuations were equal under the "Hoskold formula" to 40 per cent of the value of the estimated metal in the mine, but that for the last year the valuation amounted to 60 per cent. He added:

> The last year is a little more doubtful, but even that allows for a rate of interest of about 11 per cent, which cannot be regarded as arbitrarily low, even in such a business as mining. The plaintiff has not proved the proper interest rate for such a business.

Aside from Judge Bondy's decision in *One Liberty Street Realty & Securities Corp. v. Bowers,*[194] already noted as holding that a corporation is taxable on its average capital stock, we have found only one case in which the Department's valuation was upset: *Noyes-Buick Co. v. Nichols,*[195] involving the valuation of good will. The taxpayer had an exclusive and highly profitable agency for the distribution of Buick automobiles in New England. But the agency was not assignable, was terminable on 30 days' notice, and was said to have been granted because of the high regard of the Buick officials for the owner-manager of the taxpaying company. This owner, however, had been notified

[194] *Supra* note 183.

[195] 14 F. (2d) 548 (D.C. Mass., 1926).

that the exclusive agency would be terminated as soon as he severed his connection with the business, even though his son should take his place. Stressing the tenuous nature of this arrangement, the taxpayer claimed that its capital stock should be valued merely at the fair value of its net assets, with no allowance for good will. The commissioner, however, had added a good-will allowance of $799,000 for the year 1923, and of $700,0000 for the year 1924, to cover the excess over net asset value shown, by a capitalization of a 5-year average of net income at rates of 12.8 and 13.2 per cent. But the court threw out the good-will item completely, saying: "I cannot believe that any reasonable person would pay any substantial sum for good will, resting on such an insecure and precarious foundation."

The New Capital-stock Tax.[196]

Among the tax-service writers, no less than among the taxpayers themselves, the capital-stock tax of 1916 had many enemies. While the specific Treasury rulings were often attacked, even more criticism was leveled against a system of taxation which imposed upon the Administration the impossible task of redetermining, year after year, the "fair value" of the stock equities in 300,000 business corporations. Presumably as a result of this well-founded criticism, the tax was repealed in 1926.

But in 1933, again under the stress of an emergency requiring greatly enhanced revenues, Congress passed a new "capital-stock" tax. This time, however, the administrative difficulties of appraisal were to be avoided by a new legislative device. The taxpayer itself was free to value its capital stock at any amount. This amount, once chosen, was not to be subject to revision in subsequent tax years,[197] save for certain later adjustments. But a self-operating penalty for underassessment was created in the form of a new excess-profits tax, under which the amount of the excess profits is measured by rates of return earned on the same capital value that the taxpayer uses for the capital-stock tax. A dilemma was thus created, from which the taxpayer has no means of escape.

As a scheme for solving the administrative difficulties of valuation, this new dual tax system is almost perfect. But viewed as a method

[196] U.S.C.A., title 26, C. 18 B, Sec. 1358(a), approved Aug. 30, 1935; Sec. 1358, approved May 10, 1934; U.S. Stat., Vol. 48, Pt. 1, C. 90, Sec. 215 (73d Cong., 1st Sess., June 16, 1933).

[197] But see Oertel Co. v. Glenn, 13 F. Supp. 651 (W.D. Ky., 1936), holding, despite the tax department, that the taxpayer was entitled to correct a "mistake" in its capital-stock tax return before its excess-profits tax liability had accrued.

either for securing accurate appraisals or for securing equitable taxes, the system is without merit. What it does is to reward those taxpayers who are most fortunate in their gamble on the question whether, during future years, a low or a high valuation of their capital stock will minimize their total tax bills. In a study of valuation, therefore, this tax need be mentioned only as a clever curiosity.

Conclusions on the Federal Capital-stock Tax.

Two important but expensive lessons may be learned from the experience of the Treasury with the capital-stock tax of 1916 to 1926. The first lesson concerns the folly of a tax which requires an annual revaluation of a multitude of business enterprises. A mere slight increase in the rates of corporate-income taxation would have secured the same amount of revenues in a much more fair and economical manner. The second lesson concerns the desirability of relatively objective methods of wholesale enterprise valuation, as long as enterprise value is accepted as a tax base. The Treasury started out in a promising way, by announcing stock-market prices as the basic criterion. Its abandonment of this method was doubtless justified, at least with respect to companies whose shares were not subject to active trading. But in that case, it should have resorted to a capitalized-average-earnings method with respect to all companies with a record of earnings during the past few years. Instead, however, it seems to have used either the asset-value method or the capitalized-earnings method, whichever resulted in the higher tax, without even completely disavowing the stock-market-price method when that gave a *still* higher figure. The unfairness of this procedure is obvious. Needless to say, neither the capitalized-earnings method nor any other method, alone or in combination, would have resulted in even an approximately accurate appraisal. But in tax valuations, accuracy is out of the question, while relative objectivity is essential.

VII. THE NEW YORK SPECIAL-FRANCHISE TAX

In contrast to the Illinois capital-stock tax, under which the state courts have constantly endorsed the stock-and-bond method of valuation, is the New York special-franchise tax, under which the courts have repeatedly used a capitalized-earnings method as the *exclusive* test of enterprise value. The cases arising under this tax are of special interest in presenting perhaps the most detailed judicial analysis of the capitalized-earnings method to be found in any jurisdiction.

The Statute.[198]

Established in 1899 at the instigation of Governor Theodore Roosevelt, the special-franchise tax is a queer mixture of a corporate-excess tax with a tangible-property tax. The statute purports to base the tax on the value of the "franchise, right, or permission" of public utilities to use the "streets, highways, or public places." But it provides that this "special franchise shall be deemed to include the value of the tangible property . . . situated in, upon, under, or above any street, highway, public place, or public waters in connection with the special franchise." With the object of precluding any deductions for debts against the property, the act declares that the entire special franchise is to be treated as real estate.

The valuation is to be made by the State Tax Commission,[199] which is directed to certify its assessment to the local district in which the franchise is exercised, there to be taxed at the local and state rates applicable to other property. Public-utility tangibles not located in the public places are still subject to local assessment.

Extent of Litigation.

While the bill was pending in the legislature, it was bitterly attacked by the public utilities, which also challenged its constitutionality after its enactment. But it was fully sustained by the courts, despite arguments that it violated the principle of local "home rule" and was "impracticable and incapable of execution."[200]

The subsequent history of the tax, as told by the annual reports of the Tax Commission, has been one of continuous litigation and of unpaid taxes. According to the 1907 report,[201] more than 50 per cent of all taxes levied since 1900 remained unpaid pending decisions by the courts. Most of these disputes seem ultimately to have been settled in favor of the commission, especially those arising since 1915, when the commission announced a revision of its assessment methods in conformity with rules prescribed by the courts. Yet, in 1918, the commission reported that between 400 and 500 cases were commenced every year and that 1,600 cases were then pending. "Few of these are

[198] N.Y. Tax Law, Secs. 2 (6–7), 44–49.

[199] Prior to 1915, this body went under the name of State Board of Tax Commissioners.

[200] People ex rel. Metropolitan Street Ry. v. State Board of Tax Commissioners, 174 N.Y. 417, 67 N.E. 69 (1903), *aff'd*, 199 U.S. 1 at 48 (1905). Prof. E. R. A. Seligman stated that some of the leading public utilities advocated the administration of the special-franchise tax by a state board rather than by local assessors. "Special Franchise Tax in New York," 19 *Am. Rev. of Rev.* 716 at 717 (1904).

[201] At p. 5.

tried," it said, "it being quite apparent that most of them are commenced for the purpose of intimidating localities into compromises because of the fear of the expense of litigation."[202]

The readiness of the companies to contest their special-franchise tax is largely explained by the formidable size of the levy. According to a computation based on the years 1918 to 1920, the tax amounted to 49.3 per cent of the total state and local tax bill for local transportation companies, to 53.5 per cent for telephone and telegraph companies, to 44.7 per cent for gas and electric companies, and to 13.6 per cent for steam railroads.[203] In 1900, the total of assessments, prior to equalization, amounted to 266 million dollars; in 1930, the total of *equalized* assessments amounted to 1,000 million dollars.[204] The tax rates as well as the valuations have trended upward during most of the period of the tax.

The Tax Commission's Assessment Methods.

The statute itself prescribes no methods of valuation, nor does it even specify the types of information to be filed by the companies. During the first years, the Tax Commission failed to reveal its own methods either in its reports or in court. Instead it announced that it would be bound by no "inflexible, hard-and-fast, cast-iron rule," and that "each case must be individually considered with the elements and factors affecting it."[205] It did, however, call for the filing of returns giving information as to capitalization, dividend and interest payments, gross earnings and operating expenses, assessed values of locally assessed real property, and replacement cost (new and depreciated) as well as original cost of tangible property.[206]

In 1908, the commission complained that it had no voice in the selection of counsel in special-franchise-tax litigations, and that the attorney-general's office never consulted with it "respecting the basis of the assessments or the theory upon which they were made."[207] In consequence, the courts had no alternative but to pass on the

[202] 1918 report, p. 27. In 1926 the commission reported that from two to three thousand cases were then pending, and that an average of 300 cases had been instituted annually from 1922 to 1926. However, the commission's figures show a steady decrease in the number of new suits instituted: from 373 in 1922 to 268 in 1926 (at p. 17). Under Tax Law, Sec. 47, the tax districts to which the assessments are credited are burdened with the expense of litigation.

[203] N.Y. State, Commission for the Revision of the Tax Laws, Report, Leg. Doc. No. 77 (1932), p. 197.

[204] State Tax Commission, 1934 report, p. 128.

[205] 1900 report, p. 22.

[206] See 1901 report, p. 36; 143 App. Div. 26 at 38 (1911).

[207] At p. 5.

reasonableness of the assessment itself, without being guided by an exposition of the method by which the valuation had been reached. Against the protests both of the Tax Commission and of the utilities, the referees and courts fixed upon a valuation of the "intangible" element of the special franchise based on a capitalization of net earnings in excess of a "fair return" upon the tangible property. For this purpose, the tangibles were valued at the estimated depreciated replacement cost of structures plus the "market value" of land.

In its 1909 report, the commission protested against the judicial reliance on the net-earnings rule. "In most of these cases," it conceded, "the net-earnings rule is valuable as a test, but more often than otherwise deceptive and unreliable as a fixed standard. . . . " Its chief objections to the rule were that the companies' earnings statements were often unreliable and that value is dependent on other things than on recent earnings.[208]

Apparently the commission remained unreconciled to the net-earnings rule until 1915. In that year, the State Board of Tax Commissioners was replaced by the State Tax Commission, which undertook a reorganization of assessment procedure. Asserting that the methods theretofore used had been "different" and "contradictory," it introduced new forms of returns and "approved methods of computation and principles of valuation."[209] In its reports for 1918, 1919, and 1926, it stated that "it invokes the net-earnings rule whenever it is possible to do so."[210]

So far as concerns the special-franchise assessment of *tangible* properties, the commission throughout its history seems to have accepted depreciated replacement cost as the basis of valuation, at least in theory. But these assessments have been subject to relatively little litigation despite the fact that they have become much larger than the assessments of the intangibles. In 1916, the first year for which we have separate figures, the unequalized tangible assessments amounted to 308 million dollars, and the intangible assessments, to 330 million. But by 1934 the corresponding figures were 999 million and 183 million dollars.[211]

The Cases.

People ex rel. Jamaica Water Supply Co. v. State Board of Tax Commissioners.[212] In view of the many decisions dealing with special-

[208] At pp. 5 *et seq.*
[209] 1915 report, p. 17.
[210] 1918 report, p. 20; 1919 report, p. 21; 1926 report, p. 19.
[211] 1934 report, p. 128.
[212] 196 N.Y. 39, 89 N.E. 581 (1909), *mod'f'g* 128 App. Div. 13, 112 N.Y. Supp. 392 (3d Dept., 1908).

franchise valuation, we confine our study to the leading cases. The basic case is the one just cited, decided by the Court of Appeals in 1909. The utility had complained of its assessment of $800,000, and the lower court directed a hearing before a referee. Only the utility introduced evidence, the nature of which is not stated in the opinions. The referee valued the tangible properties in the streets at depreciated replacement cost. He valued the intangible element of the special franchise by computing net earnings for the preceding year, by deducting therefrom a 5 per cent return on the aggregate value of the company's tangibles in and out of the streets (based on depreciated replacement cost of structures and original cost of land), and by capitalizing the remainder at 7 per cent. The addition of his value for the tangibles in the streets to his value of the intangibles gave a total special-franchise value of $906,053, and he therefore upheld the assessment.

On appeal from the order of the lower court confirming the referee's report, the utility argued that the net-earnings rule was "arbitrary and misleading, and necessarily includes in the assessment intangible elements contributing to such earnings not constituting a part of the special franchise." What method it proposed to substitute does not appear. It did not contest the valuation of its tangible property in the streets at depreciated replacement cost. Counsel for the tax commissioners argued that the assessment should not be overturned even if shown to be in excess of the result reached by the net-earnings rule or by "any other one theory or rule." Only the city of New York, also a party to the action, was willing to accept the earnings test as final.

The Appellate Division squarely adopted the earnings rule, saying: "The intangible property in the street has no market value, and there is no way of determining its true value except by basing its value upon the earnings which such rights produce. . . . " But it thought that the referee was in error (*a*) in not deducting as an operating expense taxes "including approximately the amount of the special-franchise tax to be assessed"; (*b*) in not deducting depreciation in addition to maintenance; (*c*) in not taking land at its present value; (*d*) in not estimating the return upon tangibles at 6 per cent; (*e*) in not also taking 6 per cent as the capitalization rate; and (*f*) in using the earnings and expenses of a single year instead of an average over a number of years. On this last point, however, the court was content to comment without directing a recomputation.

This time, the tax commissioners and the city of New York appealed. In remitting the case to the Special Term, the Court of Appeals first stated that the commission was by no means bound by

the results of the net-earnings rule or of any other single rule. It then proceeded to give the following qualified endorsement of the net-earnings rule:

> While, as we have already pointed out, the legislature has not prescribed any exclusive or hard and fast rule for assessing the value of special franchises, we think that in the case of this relator and many other corporations similarly circumstanced the adoption and application of the net earnings rule would result in a fair and just valuation. There are obviously many cases, however, to which it would not be applicable at all. Take, for example, the case of a corporation enjoying a special franchise which by reason of mismanagement or other causes had yielded no earnings perhaps for many years; there it might be wholly contrary to the truth to hold that the special franchise of such corporation had no value simply because there happened to have been no earnings by which that value could be measured. Since, however, the net earnings rule may often be employed with convenience and justice and doubtless could justly be adopted in the case at bar, it is proper for us to make some observations in regard to the manner of applying it and the ascertainment of the elements necessary for its application.

In effect, the court's decision reduced itself to the proposition that assessments will be overthrown if not in conformity with the earnings test, in cases where this test may properly be applied, unless the tax commissioners introduce other evidence supporting the assessment. In no subsequent case coming to our attention has any such other evidence been introduced; and thus, in practice, the earnings rule has become the exclusive judicial test.

There remained for consideration the points of disagreement between the Appellate Division and the referee; and on these points the Court of Appeals held as follows:

First, in the determination of capitalizable net earnings, taxes must be deducted. At first the court held that no deduction need be made for the special-franchise tax itself. But on rehearing, it declared that, while "the very special franchise tax then in process of ascertainment" might not be deducted, yet, if the valuation is based on net earnings of some year in which such a tax has been paid, the latter tax must be deducted.[213]

Second, there must be an allowance for depreciation in addition to the actual outlays for current maintenance:

> We suppose that judicial notice may be taken of the fact that in the conduct of many industrial enterprises there is a constant deterioration of the

[213] 197 N.Y. 33, 90 N.E. 112 (1909). For the proper methods of deducting the amount of a litigated tax, see *supra* pp. 257–258.

plant which is not made good by ordinary repairs which, of course, operates continually to lessen the value of the tangible property which it affects. The amount of this depreciation differs in different enterprises, but the annual rate is usually capable of estimate and proof by skilled witnesses.

Third, in the valuation of the tangibles on which a "fair return" is to be deducted, land must be included at its "present value" rather than at its original cost. Here the court relied on the position of the United States Supreme Court in *Willcox v. Consolidated Gas Co.*,[214] a rate case, and said in language pertinent to a rate case but quite beside the point in a tax case:

> . . . it must be assumed that the present owners are entitled to a reasonable return upon the value of their property now. A stockholder who has recently acquired his stock will probably have paid an increased price therefor by reason of the increase in the market value of the very land in question.

Fourth, the use of a 6 per cent return on the tangibles was deemed proper in the absence of countervailing evidence. Again citing for support *Willcox v. Consolidated Gas Co.*, the court said:

> We think that the court below might properly assume, as a matter of general knowledge in the business community, that a prospective return of at least the legal rate of interest, which is 6 per cent in this state, is requisite to induce investors to embark their money in enterprises of such a nature as that undertaken by the relator.

Fifth, "in view of the character of the business of the relator," the 7 per cent capitalization rate, adopted by the referee "to provide a sinking fund for unforeseen contingencies," was deemed preferable to a 6 per cent rate.

Sixth, the use of a single year's record of earnings was not discussed, probably because neither party had argued the point.

As a result of subsequent decisions, the formula of the *Jamaica Water* case has come close to being rigidified into hard-and-fast law. Indeed, it is the most striking approach to a rigid valuation formula that has come to our attention in our entire study of legal appraisal. To be sure, the opinions have continued to repeat the doctrine that no one method of valuation is final. So far, however, this doctrine has been given little effect in practice. A valuation of the tangible property at depreciated replacement cost, and a capitalization of net earnings at 7 per cent, after the allowance of a return of 6 per cent on the tangibles, has been accepted in most of the reported cases. Few of the opinions in these cases reveal whether use has been made of the

[214] 212 U.S. 19 (1909).

earnings of a single year, or of several recent years. But in those cases which are explicit on the point, the first alternative has been adopted. In a later paragraph, we shall refer to the recent practice of the Tax Commission.

People ex rel. Brooklyn Heights R. R. v. State Board of Tax Commissioners.[215] Two years after the Court of Appeals' decision in the *Jamaica Water* case, the Appellate Division sustained a lower court's decision upsetting an assessment of the intangible portion of a "special franchise" on the ground that no assessment whatever was warranted by the net-earnings rule. In a previous annual report, the commission had suggested that the intangible assessment should be set at least at the "fee value of the land occupied"; but it did not explain what it meant by this phrase.[216] The Appellate Division, however, held that the mere fact that the net-earnings rule produced no assessment did not make it inapplicable.

People ex rel. Hudson & Manhattan R. R. v. State Board of Tax Commissioners.[217] While the issue in the *Brooklyn Heights* case was not passed upon by the Court of Appeals, a similar issue was presented to that court in the case now cited. Here the taxpayer contended, among other things, that since its rapid-transit line under the Hudson River had not yet been completed, its tangible property should be assessed at scrap value, and its intangible property at zero. The Court of Appeals rejected the first contention but upheld the second. As to the first, it said:

> The expert evidence shows that the assessed valuation of the tangible property does not exceed the cost of reproduction. The relator, however, contends that the cost of reproduction does not necessarily determine the value of the property. That proposition may be conceded, but nevertheless it is some evidence of value. In 1908 no part of the relator's tunnel, structures and roadway was so far completed as to enable it to put any part of its railroad in operation. It may possibly happen that when the work is completed and the railroad operated, the enterprise will turn out to be so unremunerative as to make the tangible property worth less than the cost of reproduction. On the other hand, it may be that the expectations of the promoters of the enterprise will be realized or exceeded and the road prove highly profitable. The promoters evidently had faith in it, for they continued its prosecution. There is no claim that there has been any mistake in the plans or construction of the work which necessitates the abandonment or replacing of any part of the

[215] 146 App. Div. 372, 131 N.Y. Supp. 49 (3d Dept., 1911), *aff'd, but not on the merits*, 204 N.Y. 648, 97 N.E. 1113 (1912).

[216] 1909 report, p. 8.

[217] 203 N.Y. 119, 96 N.E. 435 (1911).

structure and the substitution of a new structure.[218] Under these circumstances, we think until it is shown by actual experience that the structure is worth less than the cost of reproduction, such cost is the best evidence of value.

As to the intangible value, the court held that any assessment should be deferred until the railroad had become a going concern with a developed earning power. Its endorsement of the net-earnings rule was put in even stronger terms than those used in the *Jamaica Water* case. While remarking that the rule is not exclusive or universally applicable, it added: "nevertheless, in ordinary cases it is the best practical method that the taxing officers and the courts have as yet been able to evolve."

The above-quoted portion of the opinion discussing the valuation of tangible property implies that if a utility were unprosperous, a reduction from depreciated replacement cost would be in order. We have seen no case granting such a reduction under the special-franchise tax; and in the only discovered case in which the claim was pressed, the utility lost: *People ex rel. Mid-Crosstown Ry. v. State Tax Commission*,[219] already noted in Sec. II of this chapter.

People ex rel. Manhattan Ry. v. Woodbury.[220] This case, decided 2 weeks after the one just discussed, is important for its rulings as to the method of computing depreciation and as to the rate of capitalization.

In computing the annual depreciation allowance, the court below had "adopted a plan of amortization upon which an annual sum was authorized to be set apart as a sinking fund, which, by compounding the interest thereon [at 4 per cent] for a period equal to the life of the structure, tracks, engines, machinery, and rolling stock would at the end of that period create a fund sufficient to replace the property." The Court of Appeals reversed on this point and without discussion directed that "the annual allowance for depreciation should be com-

[218] In People ex rel. N.Y. Central R.R. v. State Tax Commission, 206 App. Div. 558, 201 N.Y. Supp. 673 (3d Dept., 1923), a retaining wall built by the railroad on state land was the subject of special-franchise assessment. The referee determined that a cheaper wall would have served the purpose just as well, and he computed the assessment at the estimated depreciated replacement cost of the cheaper wall. The Appellate Division reversed, saying that "the tax should be assessed on the property as it is and not as it might have been." See our discussion of this aspect of appraisal theory, *supra* pp. 163–165; *infra* pp. 1124–1126.

[219] 192 N.Y. Supp. 388 (Sp. Tr. N.Y. Co., 1921). But reductions have been granted under the New York railroad real-property tax. See *supra* pp. 521–531.

[220] 203 N.Y. 231, 96 N.E. 420 (1911).

puted by dividing the values of the various kinds of tangible property by the number of years of their respective estimated physical lives," *i.e.* the so-called straight-line method. Judge Haight discussed the depreciation problem in a separate opinion from which we quote. The precise nature of his conclusions is not clear to us; but he seems to accept the view of some public-utility accountants that replacements should be cared for largely through direct charges to operating expense, and that the depreciation reserve should take the form of a mere equalization reserve.[221]

The difficulty with such holding [the amortization plan] is that railroad corporations do not reconstruct their railroads and rolling stock in that way. In order to afford proper protection to the public they are required to maintain a high state of efficiency both in roadbed and rolling stock. . . . Old ties have to be removed and replaced with new ones; old rails that have become worn and battered have to be removed and their places supplied with new rails and so the work of reconstruction progresses from year to year. It is not the waiting forty or sixty years to reconstruct, during which time the amount set apart as a sinking fund may be doubled many times over by compounding the interest, but it is the annual expenditure for reconstruction which is to be paid for at the time that the construction is made.[222] . . . Of course, the necessities of reconstruction vary from year to year; some years it may be greater than others, but the assessors each year can easily ascertain the sum required for that purpose. . . .

I am aware that some corporations have in the past met with heavy losses by reason of their machinery becoming obsolete. . . . But there is a difficulty in making any estimate as to the amount of depreciation in the assessable value of tangible property which may result from future invention, and, therefore, this species of property should be left to be considered when such depreciation actually occurs.

In computing the amount upon which the railway was to be allowed a return, the court held that there should be included the item of "cash and other cash items on hand." "This item," it said, "may, properly, be considered as a part of the relator's working capital which it is entitled, in the prudent management of its business, to keep on hand. Whether or not it was, in fact, essential to the operation of the railroad is not material." The court refused to upset the 6 per cent rate of return adopted below in favor of a higher rate urged by the railway, since the evidence in the matter was conflicting.

The 6 per cent rate had likewise been adopted below as the capitalization rate. But the Court of Appeals held that, *as a matter of*

[221] For a discussion of this viewpoint see *infra* pp. 1127–1129.

[222] See George S. Coleman, "Special Franchise Taxation in New York," *Nat. Tax Assn. Proc.* (1907) 649 at 652–653.

law, the capitalization rate should be set at least 1 per cent higher than the rate of return. "The purpose of this," it said, "is to provide against unforeseen contingencies that may arise in the prosecution of the business of the corporation, such as unusual storms, floods, fires, explosions and accidents, which may result in the impairment of net earnings, and cannot be foreseen and estimated in advance."[223]

The tangible-property assessment was also challenged by the railway. But the court sustained the commission, holding that the cost of acquiring easements from abutting property owners in order lawfully to maintain its structure in the streets was properly includable in arriving at the value of its tangible-property assessable under the special-franchise tax.

People ex rel. Third Avenue R. R. v. State Board of Tax Commissioners.[224] Here the net-earnings rule was again upheld and elaborated. In their return to the writ of certiorari obtained against them, the tax commissioners stated that they had considered "all tests of value" and had arrived at the assessment therefrom according to judgment and not according to any specific method. Yet the only evidence introduced in the case related to the earnings rule. Counsel for the city of New York, a party to the case, argued that since the commissioners had used a composite method of valuation, it was incumbent upon the relator to show that the assessment could not be sustained by such method. But the Appellate Division said that the earnings rule was "presumptively the proper rule," and that since the city had failed to show its inapplicability, the lower court properly judged the assessment by it. The Court of Appeals affirmed, quoting from the *Woodbury* case to the effect that it was the best practical rule.

Aside from its reaffirmance of faith in the net-earnings rule, this case is important for several detailed rulings by the Appellate Division, all of which were affirmed or undisturbed by the Court of Appeals.

As usual, the trial court had taken the net earnings of the preceding year. While no issue was made of this procedure, the Appellate Division found it in accord with the net-earnings rule as established in the *Jamaica Water* case.

Despite opinion testimony by two engineers (witnesses for the taxpayer) that an 8 per cent return was necessary to attract capital,

[223] In an earlier case, the Appellate Division had said that the rate of return and the capitalization rate should be the same. People ex rel. Third Avenue R.R. v. State Board of Tax Commissioners, 136 App. Div. 155 at 158, 120 N.Y. Supp. 528 at 530 (3d Dept., 1909), *aff'd without opinion*, 198 N.Y. 608, 92 N.E. 1098 (1910).

[224] 212 N.Y. 472, 106 N.E. 325 (1914), *aff'g* 157 App. Div. 731, 760, and 763, 142 N.Y. Supp. 986, 1010 and 1012 (1st Dept., 1913).

the lower court allowed a 6 per cent return on the tangibles and was upheld by the two upper courts. The Court of Appeals said that opinion evidence is subject to the "independent judgment" of the trial court.

Although the lower court also took 6 per cent as the capitalization rate, the Appellate Division allowed 7 per cent on the authority of the *Woodbury* case, and its ruling was not contested above.

The trial court had approved an assessment of the tangible properties in the streets at depreciated replacement cost. Without contesting this assessment, the taxpayer claimed that the return on its tangibles should be based on replacement cost *new*. Its claim was overruled by the Appellate Division and not reasserted before the Court of Appeals.

In the calculation of replacement cost, as a base on which to compute the return on the tangibles, the taxpayer insisted on a 20 per cent allowance for "development expenses," including such items as legal service, securing consents from public bodies and property owners, promoter's and banker's profits or commissions, and interest and taxes during construction. Only the last two items were allowed by the Appellate Division. In affirming, the Court of Appeals said: "The record or the brief of relators does not reveal any manner in which [these other] expenses . . . add to the present cost of reproducing the tangible property or take part in producing the earnings attributable to the tangible property under the net earnings rule."

The Appellate Division held that no return should be allowed on land, buildings, and rolling stock owned by the taxpayer but unused by it and leased to other parties, and that the rental derived therefrom should not be included in the earnings, on the ground that only property "used in connection with the special franchise" should be considered. However, "in order to establish a definite rule, even though it be somewhat arbitrary," it held that a return should be allowed on the full, not merely the apportioned, value of real property partly used in the taxpayer's operations and partly rented out; and that the rental from such property should be included in the earnings. On all these points the Court of Appeals affirmed. The former court also held, or at least suggested, that interest earned on "working capital" upon which a return is allowed, should be included in the earnings. This point was not discusssed by the highest court.

Section 48 of the tax law provides that if a utility has paid to a city "any sum based upon a percentage of gross earnings, or any other income, or any license fee, or any sum of money on account of such

special franchise," then all amounts so paid, except money expended for paving or repairing pavements, shall be deducted from the amount of the special-franchise tax. The company had made such payments to the city of New York and argued that in addition to their deduction from the tax, they should be deducted as operating expense from the gross earnings. Although the arguments of the commissioners against this double deduction had been persuasive with the lower court, both the Appellate Division and Court of Appeals accepted the position of the taxpayer.

The claim of the taxpayer that taxes and special assessments *paid* by it during the year for which earnings were computed, but *accruing* in prior years, should have been deducted from gross earnings, was rejected by all courts.

The parties had stipulated that "$336,695 was a reasonable depreciation allowance to cover the amount of the annual depreciation and obsolescence of relator's property." On the trial the utility argued for the further allowance of $206,735, which it had spent during the year for "renewals and replacements." The commissioners argued that the depreciation fund should be held to cover all expenditures for renewals and replacements in order to avoid a double allowance. The Special Term adopted the commissioners' argument, but the Appellate Division reversed and granted the utility $164,745 of the $206,735 additional allowance asked for, on the ground that the former sum represented expenditures for *ordinary* repairs and for replacements of *parts* of old machinery and equipment, whereas the remainder represented expenditures for new construction, machinery, and equipment. In affirming, the Court of Appeals said:

> In *People ex rel. Manhattan Ry. Co. v. Woodbury* (203 N.Y. 231, 236) we held "that the annual allowance for depreciation should be computed by dividing the values of the various kinds of tangible property by the number of years of their respective estimated physical lives." Obviously, the "lives," as there treated, are the periods of time through which the various kinds of tangible property will respectively, with ordinary and adequate renewals and repairs, continue efficient in and commercially adaptable to their respective processes and functions. In *People ex rel. Third Ave. R.R. Co. v. State Bd. of Tax Comr's* (136 App. Div. 155, 158, *aff'd*, 198 N.Y. 608) Mr. Justice Kellogg, writing for the court, said: "*The Jamaica Water Supply Company* case establishes that a public service corporation, with reference to its property which will become worthless by use and must be replaced, is entitled to set aside each year from its earnings a reasonable sum to provide for its replacement. This is outside the ordinary annual expenses for maintenance, renewals and repairs."

People ex rel. Central Hudson Gas & Electric Co. v. State Tax Commission.[225] This is the last case on the net-earnings rule that we shall consider. The referee had employed this rule, using the earnings of the preceding year. In fact, the report of the case states that the assessment had been computed by the Tax Commission on the basis of the same rule, but it does not state what period of time the commission had adopted. The dispute arose over the application of the rule.

The taxpayer was engaged in the manufacture and sale of gas, electricity, and steam. In addition, it sold gas and electric appliances, and certain by-products such as coke. The Appellate Division held that the earnings and expenses from these incidental operations should have been included in the computation, since they were carried on in the prudent and economical operation of the special franchise enjoyed by the main business.

The referee allowed a deduction of $4,623 representing "the annual amount set aside by the relator for amortization of debt expense incurred in the sale of its bonds, representing such expenses as printing, commissions, and lawyers' fees and like expense which the company incurred in marketing such securities. It does not include debt discount." His position was upheld by the Appellate Division but, as will be seen later, was reversed by the Court of Appeals.

Donations to chambers of commerce, firemen's associations, police departments, etc., were disallowed by the Appellate Division because "not an expense incident to operating revenue." The court noted that, according to the accounting rules prescribed by the Public Service Commission, these expenses were to be charged to corporate surplus.

The Appellate Division disallowed taxes paid on account of income derived from investments—income not included in gross earnings.

The referee computed annual depreciation according to the straight-line method, although the company had made a much smaller allowance on its books. The Tax Commission contended that this smaller amount should govern, but the Appellate Division upheld the use of the straight-line method irrespective of the accounting method used by the utility.

In addition to the annual depreciation allowance, the referee allowed an additional item for obsolescence caused by the removal of two generating units and their replacement by more modern machinery. This item was set at "the value of the unexpired physical life of these units." Said the Appellate Division:

[225] 218 App. Div. 44 at 60, 217 N.Y. Supp. 707 at 722 (3d Dept., 1926), *on rearg.*, 219 App. Div. 227, 219 N.Y. Supp. 445 (1927), *modified*, 247 N.Y. 281, 160 N.E. 371 (1928).

This element was not covered by the item of depreciation which contemplates the use of property to the end of its physical life. "This species of property should be left to be considered when such depreciation actually occurs." (*People ex rel. Manhattan Railway Co. v. Woodbury*, 203 N.Y. 231, 240.) Our interpretation of the rule as laid down by the Court of Appeals in that case is that such depreciation actually occurs when the property is removed from service.

The referee allowed as a part of "working capital" an item of $50,000 representing average bank balance, and an item of $44,552 for [average?] materials and supplies on hand. He also allowed the sum of $79,727 representing 2 months' average expenses, since the relator "has to finance its operations for a 2-month period, which is the average period which it has to wait for its collections from its customers." The taxpayer contended that the referee should have allowed an additional amount representing 2 months' average revenues; while the Tax Commission argued that 4 months' average expenses should have set the maximum to the entire working-capital allowance. The Appellate Division upheld the referee.

The Appellate Division held that the cost of tearing up and replacing pavement to enable relator to install its property in the streets should have been included in the value of that property both for purposes of assessment and for purposes of computing the amount of deductible return.

The referee allowed a 6 per cent rate of return for 1916 and 1917, 6½ per cent for 1918, and 7 per cent for 1919. The Appellate Division, holding that these rates were supported by the evidence, said: "The rule seems to be that the rate of return is determined by what rate is requisite to induce investors to embark their money on enterprises such as that undertaken by the relator." In support of this statement it cited the *Jamaica Water* case. It also cited a 1919 rate-making decision of the United States Supreme Court, *Lincoln Gas and Electric Light Co., v. Lincoln*,[226] in which that Court had remarked that "returns upon capital and enterprise the world over have materially increased."

The taxpayer required applicants for its service to share the cost of extending its gas and electric service into their premises. It claimed that, under the accounting rules of the Public Service Commission, the amounts so paid by consumers were to be kept in a special capital-reserve fund from which dividends were not payable, and therefore should not be included in computing the earnings to be capitalized. The Appellate Division held that if the relator's claims

[226] 250 U.S. 256 (1919).

were true, these payments should not be included in the earnings, but that they should then be deducted in arriving at the value of the relator's tangible property upon which a return is allowed.

The decision of the Appellate Division, after a reargument in that court, was appealed by both parties to the Court of Appeals. The latter court affirmed as to all the matters discussed above, except that it refused to allow as operating expense the item of amortization of "debt expense," previously discussed, on the ground that it was an expense incurred in raising new capital, which the stockholders were unable or unwilling to contribute themselves, and that they, and not the operation of the special franchise, should be charged with this expense. This holding was sound, although the apologetics are somewhat confused.

The Tax Commission's Application of the Net-earnings Rule.

We have already noted that, after previously declining to be bound by the net-earnings rule, the Tax Commission, yielding to pressure from the courts, undertook to adhere to it in 1915 and thereafter. Something may now be said as to the commission's detailed methods of application. On this point the annual reports supply few data. The 1919 report stated that, because of war and post-war conditions, a 5-year average was generally used to do away with "violent fluctuations," and that the rate of capitalization was "usually" set at 1 per cent higher than the rate of return.[227] The 1918 report said that no revisions were made in order to take account of probable future improvement in the earnings of utilities.[228] The recent method of applying the earnings rule is revealed by the following quotations from two communications which we have received from the Tax Commission, dated Nov. 19 and 30, 1934:

> However, it has been the practice of this Department for several years to use the average earnings for a five-year period in our net-earnings-rule computations for special franchise valuations.
>
> The rate of return that is allowed has been changed at various times. At the present time in our five-year computations we are allowing a return of 7 per cent for the first three years and 6 per cent for the last two years.
>
> It has always been our practice to capitalize the excess earnings at least 1 per cent higher than the rate of return.
>
> When a return is allowed [as above] . . . we capitalize the five-years' average net earnings at 1 per cent more than the average return, that is, at 7.6 per cent.

[227] At pp. 21–22.
[228] At p. 19.

In recent years we have adopted a sliding scale rate of capitalization. This scale provides for the use of a higher rate of capitalization as the earnings increase in per cent of the rate base.

The sliding scale rate of capitalization was adopted on account of the uncertainty of the continuation of high excess earnings. Abnormally high excess earnings, in the case of public utilities, are apt to be unstable on account of the right of the regulatory commissions to reduce rates.

In our five-year calculations we deduct all taxes which are applicable to the operations of the five years involved including special franchise taxes. We do not, however, make any deduction for the estimated special franchise tax that is to be paid on the valuation we are making.

Apportionment.

In discussing the application of the net-earnings rule under the special-franchise tax, we have so far ignored the problem of apportionment. This problem has arisen in two connections. In the first place, the tax purports to be based merely on the value of the "special franchise" to use the streets and other public places, and not on the entire franchise to conduct a utility business. The argument might therefore be made that only a certain portion of the "corporate excess" (which is supposed to measure the entire intangible, franchise value) should be imputed to this "special franchise," and that the other portion should be imputed to the right to use the tangible assets located on *privately* owned land. In the second place, if the wire, pipe, or track of a utility company extends beyond the limits of a single tax district, by what method shall the Tax Commission determine the value of the right to use the streets of any one district?[229]

It is hardly necessary to point out that, from the standpoint of appraisal theory, these questions are absurd. But they are inevitably raised by a tax which, in its very nature, makes absurd distinctions between tangible and intangible values, and between those intangible values that are created by the use of the streets and those otherwise created.

With *tangible* special-franchise assessments no apportionment is required, since tangible properties are valued at their estimated

[229] Frequently the problem of apportioning earnings or expenses between parent and subsidiary also arises. See People ex rel. Brooklyn Heights R.R., v. State Board of Tax Commissioners, 146 App. Div. 372, 131 N.Y. Supp. 49 (3rd Dept., 1911), *aff'g* 69 Misc. 646, 127 N.Y. Supp. 825 (1910); People ex rel. Third Avenue R.R. v. State Board of Tax Commissioners, 157 App. Div. 731 at 742, 142 N.Y. Supp. 986 at 998 (1st Dept., 1913); People ex rel. Metropolitan Street Ry. v. State Board of Tax Commissioners, 159 App. Div. 136, 144 N.Y. Supp. 74 (1st Dept., 1913), *aff'd without opinion*, 212 N.Y. 606, 106 N.E. 1040 (1914).

depreciated replacement cost. This statement apparently applies not only to the wires, pipes, etc., of local utility companies, but also to the railroad structures in or on grade crossings.[230]

A peculiar problem presents itself with the "intangible value" represented by the right of a railroad to use the public crossings. Since by far the larger portion of a steam-railroad line is on a private right of way, the attribution of the railroad's entire "corporate excess" to the use of publicly owned land would seem absurd on its face. How the Tax Commission actually computes this value has not been revealed in its reports or in the litigated cases. In its 1915 report, it stated that it arrived at the value of the right to occupy a grade crossing, not by the net-earnings rule, but by a method "the underlying factor in which is the railroad's use of the crossing"; and with this cryptic remark it has rested content.[231]

Problems of apportionment were involved in the case last discussed: *People ex rel. Central Hudson Gas & Electric Co. v. State Tax Commission.*[232] The Appellate Division held, first, that the capitalized excess earnings "should be distributed among the various tax districts upon the relation which the gross receipts from each district bear to the total gross receipts of the system"; and second, that the amount distributed to each district should be further abated in the ratio that "the length of the wires over public ways bears to the total length of all such wires in such town." Whatever else may be said as to these rules of apportionment, they are objective and simple. On appeal to the Court of Appeals, the first factor of apportionment was upheld without discussion, but the second was upset. Two opinions were delivered, one by Judge Crane in which all concurred except Judge Cardozo, and another by the latter in which all concurred. Judge Crane's opinion does not clearly reveal whether he is objecting to *any* apportionment, under the earnings rule, between private and public right of way, or whether he is objecting merely to the linear method of apportionment whereby a mile of wire over wild Adirondack land is assigned the same value as a mile of wire through the streets of a congested city. Judge Cardozo simply declared that no apportionment should be permitted so long as the utility was unwilling to forego a return on the value of its private right of way; in

[230] People ex rel. N.Y. Central & Hudson River R.R. v. Woodbury, 167 App. Div. 428, 153 N.Y. Supp. 537 (3d Dept., 1915).

[231] See State Tax Commission, 1915 report, p. 18; 1919 report, p. 22. In 1934, the intangible assessments levied against steam railroads amounted to 32 million dollars; the tangible assessments, to 61 million.

[232] *Supra* note 225. See Note, 57 A.L.R. 379 (1928).

other words, that the utility could not have both the return and the apportionment.

Problems of apportionment have arisen in a number of other cases,[233] but under the special-franchise tax these problems are so artificial, and their solution so arbitrary, that their discussion would hardly be worth while.

Conclusions on the Special-franchise Tax.

A mere exposition of the nature and history of this tax is sufficient to indicate the desirability of its repeal. Indeed, its repeal has been urgently sought by the Tax Commission[234] and by special legislative committees appointed to investigate the New York tax system.[235] These committees have advocated the adoption, in its stead, of central assessment of all public-utility "operative property," and of a gross-net earnings tax.

The chief points of interest provided by the judicial administration of the tax are: (*a*) the exclusive use, in practice, of capitalized earnings in order to value "corporate excess"; (*b*) the use of a single year's record of earnings, and the refusal of the Tax Commission to follow the courts in this particular; (*c*) the use of the "straight-line method" of computing the annual depreciation allowance; (*d*) the use of depreciated replacement cost as the value of the tangible property, both for the purpose of computing the "fair return" to be deducted from net earnings prior to capitalization, and for the purpose of direct assessment; (*e*) the use of a capitalization rate higher than the rate of return allowed on tangible property; and (*f*) the customary use of 7 per cent as the rate of capitalization, and of 6 per cent as the rate of return.

VIII. RAILROAD AND UTILITY ASSESSMENTS: FEDERAL CASES[236]

It remains to discuss a number of important Federal cases dealing with public-utility valuation for tax purposes. Most of these cases

[233] See People ex rel. Mexican Telegraph Co. v. State Tax Commission, 219 App. Div. 401, 220 N.Y. Supp. 8 (1st Dept., 1927); People ex rel. N.Y. Central & Hudson River R.R. v. Priest, 206 N.Y. 274 at 299 *et seq.*, 99 N.E. 547 at 555 *et seq.* (1912); People ex rel. Commercial Cable Co. v. State Board of Tax Commissioners, 99 Misc. 532 at 537 *et seq.*, 166 N.Y. Supp. 62 at 66 (Sp. Tr., 1912).

[234] 1918 report, p. 26; 1926 report, pp. 16–18; 1934 report, p. 19.

[235] State of New York, Report of Special Joint Committee on Taxation and Retrenchment (Albany, 1925), p. 86; same, Report of Commission for the Revision of the Tax Laws, Leg. Doc. No. 77 (1932), p. 196 *et seq.*

[236] Compare the review of state and Federal cases in one of the ablest analyses in the entire field of legal valuation: Maurice Ravage, "Valuation of Public Utilities for Ad Valorem Taxation," 41 *Yale L. J.* 487 (1932).

are concerned with state assessments of interstate railroads. In so far as they raise the problem of allocating to a given state some share of the appraised value of the entire system, they will be noted in the two following chapters, on the unit rule. But in so far as they present the problem of evaluating the whole enterprise, they will be treated in the present section.

Early Supreme Court Cases.

The latter part of the nineteenth century witnessed a series of Supreme Court decisions firmly establishing the principle that a state has the power to tax a public utility (and presumably any other business) upon its enterprise value and not merely on the value of its tangible assets. In line with the views of modern economists, these decisions emphasize profitableness, rather than original cost or replacement cost, as the determinant of value. But oddly enough, they were rendered during the same period in which the Court was developing its very different concept of value in rate cases, without clearly recognizing the distinction.[237]

We have already noted the pioneer *State Railroad Tax Cases*[238] (1876), sustaining the assessment of railroad properties at their enterprise value as measured by stock and bond quotations. This was followed by the *Indiana Railroad Tax* cases (1894),[239] which extended the same principles to interstate railroads. Here Justice Brewer stated that, while a property tax is based upon the value of the property and *not* upon its earnings, nevertheless "the value of property results from the use to which it is put and varies with the profitableness of that use, present and prospective, actual and anticipated."

In *Western Union Telegraph Co. v. Taggart,*[240] decided in 1896, the Court again reaffirmed its faith in the stock-and-bond method, as applied to a telegraph company by the Indiana state board. In vain did the company contend that the assessment, which was set at $2,297,652, should be limited either to the actual cost of its telegraph line ($686,126) or to the replacement cost ($1,226,625). "The cost of the property, or of its replacement," said Justice Gray, "is by no means a true measure of its value."

[237] *Infra* pp. 1092–1103.

[238] 92 U.S. 575 (1876), discussed *supra* p. 553 and *infra* p. 642.

[239] Pittsburgh, Cincinnati, Chicago & St. Louis Ry. v. Backus, 154 U.S. 421 (1894); Cleveland, Cincinnati, Chicago & St. Louis Ry. v. Backus, 154 U.S. 439 (1894). See *infra* p. 645.

[240] 163 U.S. 1 (1896), discussed *infra* p. 650. See Atchison, Topeka, & Santa Fe Ry. v. Sullivan, 173 Fed. 456 (C.C.A. 8th, 1909).

Finally, in the celebrated case of *Adams Express Co. v. Ohio State Auditor*,[241] the Court was so positive in its approval of an assessment of business property at its enterprise value that the point has never again been seriously contested before it. No particular method of valuation was here at issue. The complaint of the express companies was based on the fact that their assessments exceeded by many times the aggregate values of their tangible properties, plus their money and credits, located in the state. But Justice Brewer, speaking for the Court, insisted that taxable property is by no means limited to tangible property:

> Now, whenever separate articles of tangible property are joined together, not simply by a unity of ownership, but in a unity of use, there is not infrequently developed a property, intangible though it may be, which in value exceeds the aggregate of the value of the separate pieces of tangible property. Upon what theory of substantial right can it be adjudged that the value of this intangible property must be excluded from the tax lists, and the only property placed thereon be the separate pieces of tangible property?

The Justice also stressed what he called the "cardinal rule" that "whatever property is worth for the purposes of income and sale it is also worth for purposes of taxation." To be sure, he conceded,

> If a statute, properly construed, contemplates only the taxation of horses and wagons, then those belonging to an express company can be taxed at no higher value than those belonging to a farmer. But if the state comprehends all property in its scheme of taxation, then the good will of an organized and established industry must be recognized as a thing of value.

Stock-and-bond Method versus Capitalization of Earnings.

Although the Supreme Court's decisions culminating in the *Adams Express* case definitely established the power of a state to tax enterprise values, they by no means eliminated sharp controversies as to the proper methods of estimating these values. One of these controversies, which still persists, concerns the relative merits of the stock-and-bond method and the capitalized-earnings method.

We have already noted the early decisions by the Supreme Court sustaining assessments based on stock and bond prices and implying that no more reliable basis of appraisal is available. These decisions have never been repudiated. But the Court has subsequently made it

[241] 165 U.S. 194 (1897), *rehearing denied*, 166 U.S. 185 (1897). Argued at the same time, and decided on the authority of the foregoing case: Adams Express Co. v. Kentucky, 166 U.S. 171 (1897); Henderson Bridge Co. v. Kentucky, 166 U.S. 150 (1897).

clear that it will respect other methods of valuation,[242] especially those based on a capitalization of average recent net earnings or on a "judgment estimate" which takes into account a number of indices of value. Thus, in *Ray Consolidated Copper Co. v. United States*,[243] which arose under the Federal capital-stock tax, it upheld an assessment materially in excess of the value that would be shown by the stock-and-bond test; and in *Great Northern Ry. v. Weeks*[244] it upset an assessment which was not supported by the capitalized-earnings test.

The majority of recent opinions by the lower Federal courts show a preference for a valuation which gives weight to several different factors, with emphasis on earnings and on stock and bond prices. But there is a tendency to favor the earning-power test and to deny to the stock-and-bond test as much significance as the Supreme Court attached to it in its early opinions.

In *Norfolk & Western Ry. v. Board of Public Works of West Virginia*,[245] the Federal district court upheld the assessment despite the railroad's claim that the only proper "yardstick" of valuation was the market-price values of its stocks and bonds on assessment date. Calling attention to the wide fluctuations in market prices from day to day, the court expressed a preference for what it called "the composite method," saying:

> While some courts favor one method as being more fair than other methods and other courts favor still other methods, yet an examination of the opinions shows that the courts as a whole are very much inclined to the consideration of all factors.

As the assessors' valuation of the whole railroad was amply justified by the reported earnings, as an allocation factor that gave weight to almost every consideration had been used, and as the assessment was far below the Interstate Commerce Commission's "physical valuation," the court declined to interfere.

The exclusive use of a stock-and-bond valuation was also vainly urged by the taxpayer in *Pleasant v. Missouri-Kansas-Texas R.R.*[246] Denying the contention that the Kansas statute impliedly required

[242] See, for example, Illinois Central R.R. v. Greene, 244 U.S. 555 (1917), sustaining the district court for holding it within the discretion of the assessors to choose either a capitalized-income method or a stock-and-bond method of appraisal. For a similar position as to the broad discretion of the assessors, see Louisville & Nashville R.R. v. Greene, 244 U.S. 522 (1917).

[243] 268 U.S. 373 (1925), discussed *supra* p. 590.

[244] 297 U.S. 135 (1936), discussed *infra* p. 627.

[245] 3 F. Supp. 791 (S.D. W. Va., 1933).

[246] 66 F. (2d) 842 (C.C.A. 10th, 1933), *cert. denied*, 291 U.S. 659 (1934).

the state board to abide by a stock-and-bond rule, the court sustained the taxes for 1929 and 1930 and expressed a preference for the earnings method:

The capitalization of earnings method is more dependable, particularly in times of wild speculation, than the value of the stocks and bonds. At present, and during the years in question [1929 and 1930], the stock market reflected the hopes or fears of a speculating public more accurately than the taxable values of roadbed and equipment.

In *Cumberland Pipe Line Co. v. Lewis*,[247] on the other hand, the district court favored the stock-and-bond method and refused to accept the contention of the Kentucky tax board that, under the decisions of the state courts, it was bound to accept as final a capitalization of earnings.[248] We quote from the opinion:

Where the stock and bonds of the corporation, or stock alone, if there are no bonds, have a market value, there is no reason why this method should not ordinarily be followed. In the cases of *Railroad & Telephone Cos. v. Board of Equalizers of Tennessee*, 85 Fed. 302, and *Chicago Union Traction Co. v. State Board*, 112 Fed. 607, this method was subjected to criticism, but this on the ground that it gave an exaggerated valuation of the property represented by the stocks and bonds. Those cases concerned railroad, telephone, and street car companies, and arose in the days of stock-watering and manipulation. The criticisms made in those cases can hardly be made now, and the market values of the stocks and bonds of such companies, at present, are, in the absence of something exceptional, a fair test of the valuation of the property represented by them.

However, the real complaint of the taxpayer lay, not in the use of the earnings method, but rather in its wrongful application. Although the pipe line was a "wasting-asset" enterprise, the state board had valued the enterprise as if it might have been expected to yield a perpetual annual income.

The sharpest judicial criticism of the stock-and-bond method is to be found in *Railroad & Telephone Cos. v. Board of Equalizers of Tennessee*.[249] There the court expressed its contempt of "Wall Street quotations called market prices," of "the bulls and bears of Wall Street," and of "the manipulated figures of the stock exchange." But

[247] 17 F. (2d) 167 (E.D. Ky., 1921). See *supra* note 193.

[248] Under its "franchise tax" Kentucky has usually made use of the capitalized-earnings method. Ravage states that the Kentucky statutes "have occasioned more valuation litigation, perhaps, than any other state with the exception of New York." *Op. cit.*, 41 *Yale L.J.* at 496, n. 34.

[249] 85 Fed. 302 (C.C. N.D. Tenn., 1897).

most of the Federal courts, while conceding the many flaws in the assumption that an entire business enterprise is worth whatever amount is shown by a summation of stock and bond prices, reply that *all* methods of appraisal are imperfect and that the results of various methods should be checked against each other as a means of securing a cancellation of opposing errors.

So far as concerns the two methods of appraisal now under review, we conclude that a few Federal courts still favor the stock-and-bond method, that a somewhat greater number place more faith in a capitalization of realized earnings, but that most of them prefer to "give weight" to both methods. The position of the Illinois courts under the capital-stock tax in relying solely on the stock-and-bond test, or that of the New York courts under the special-franchise tax in using exclusively a capitalized-income test, while entirely reasonable under the tax systems as administered in these states, is not typical of the Federal courts, which generally prefer an eclectic test.

As pointed out by Ravage,[250] however, the adoption of the stock-and-bond test on the one hand, or of the capitalized-earnings test on the other hand, is ordinarily far less important than is the detailed *application* of either of these methods. Under both methods, the choice of the particular period of stock quotations or of annual earnings may make a world of difference; and under the capitalized-earnings method, the whole case may turn on the acceptance of this or that rate of capitalization. Yet on problems of this nature appraisal theory has little to offer except a few rather obvious generalizations.[251] Unless one is satisfied with factitious "valuations for tax purposes" (a very reasonable attitude), all rules of thumb, such as the use of a 3-year average of earnings and of a 6 per cent rate of capitalization, are unacceptable.

As to the period for which earnings or stock-market prices should be averaged, nearly all the cases prefer a record of several years.[252] The New York special-franchise-tax cases, previously discussed, which use a

[250] 41 *Yale L.J.* at 498.

[251] See *supra* pp. 259–264.

[252] In valuing a railroad property, assessors ordinarily "should look to the average showing made by a series of years—say, not less than five," since it is essential "to cover a sufficient period to show the settled condition of things." Louisville & Nashville R.R. v. Coulter, 131 Fed. 282 at 304 (C.C.E.D. Ky., 1903), *rev'd*, 196 U.S. 599 (1905). See also our later summary of the opinion in Northern Pacific Ry. v. Adams County, 1 F. Supp. 163 (E.D. Wash., 1912), *rev'd in part but not on the merits*, 72 F. (2d) 816 (C.C.A. 9th, 1934).

In Chicago Union Traction Co. v. State Board of Equalization, *supra* note 132, the court capitalized the earnings of a single year but remarked that the year did not seem to be exceptional. At the same time it upset an assessment based

single year's earnings, are exceptional and tend to convert what purports to be an ad valorem tax into an income tax—perhaps wisely so. An average of from 3 to 5 years is typical. But the courts are more concerned to secure a "representative" average, which may be assumed to reflect future prospects of earnings or of stock-market prices, than they are to abide by any conventional period of time. Sometimes they ignore entirely the record of a very recent year on the ground that it was of a nonrecurrent nature.

As to the rate at which earnings are capitalized, our study supports Ravage's statement that the problem is generally treated in a very cursory manner. With railroads, a 6 per cent rate has been conventional as a test of the validity of an assessment;[253] and its use is often defended by no better argument than that it is the legal rate of interest in the particular state, or that it has been sanctioned as the basis of the "reasonable rate of return" in rate cases. The Supreme Court has expressed a readiness to leave the choice of a rate to the discretion of the assessors.[254] But one notes with surprise the superficial way in which the problem is treated by those courts that are meticulous—one might even say hypercritical—in scrutinizing other aspects of the assessment procedure.

Replacement Cost as a Factor in Enterprise Valuation.

Of far more importance than the choice between the stock-and-bond method and the capitalized-earnings method of valuation is the question whether, and to what extent, weight should be given to so-called "asset values" or "physical values" based on estimates of replacement cost minus allowances for depreciation. The answer to this question may be the decisive factor in testing the legality of an assessment challenged by a company with low recent earning power. With such a company, both the stock-and-bond method and the

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on the stock-and-bond method, among other reasons, because the assessors had used the stock-market prices of a single day.

In the choice of a period for the ascertainment of representative earnings or of stock-market prices, the Supreme Court has upheld the lower courts in allowing wide discretion to the assessors. Illinois Central R.R. v. Greene, and Louisville & Nashville R.R. v. Greene, *supra* note 242.

[253] See, for example, Northern Pacific Ry. v. Adams County, *supra* note 252; Pleasant v. Missouri-Kansas-Texas R.R., *supra* note 246. In the latter case, the Circuit Court substituted 6 per cent for the district court's 7 per cent and disagreed with the taxpayer's argument that an extra 1 per cent should be allowed for depreciation not reported in the railroad's earnings annual statement.

[254] See Illinois Central R.R. v. Green, and Louisville & Nashville R.R. v. Greene, *supra* note 242

capitalized-earnings method will usually point to a low valuation. But if the company owns costly tangible assets, a valuation based largely on replacement cost with conventional deductions for depreciation will nevertheless support a high assessment. During the past several years, for example, substantially every railroad in the country, if valued by either of the two former methods, would be found to be worth much less than their "physical values" as set by the Interstate Commerce Commission.

We have already noted that in New York and New Jersey (as well as in other states whose tax systems have not been canvassed), the statutes as interpreted by the state courts do not contemplate the assessment of a railroad as an entire business *enterprise*. Here the tangible property (or at least the real property) is valued separately by reference to depreciated replacement cost. Whether or not these tangible-property assessments will pass the test of Federal constitutionality even if they are shown to exceed the entire value of the railroad *enterprise* is a question on which the Supreme Court has not yet squarely passed. But we are now concerned with the different question whether the replacement cost of the tangible assets of a company should be accorded any weight even when the amount of the assessment is concededly based on, or limited by, the value of the enterprise as a going concern. Chapter XII discusses this problem from the standpoint of appraisal theory, and other chapters treat the precedents in various fields of law.[255] It remains to mention pertinent Federal decisions in utility taxation.

Broadly speaking, the Federal cases agree that replacement-cost data (and even original-cost data, presumably because of their bearing on replacement cost)[256] are admissible in proof of taxable enterprise value. But also broadly speaking, the recent decisions tend to belittle the significance of all cost estimates and to lay stress on earnings and on stock and bond quotations.

Chicago & North Western Ry. v. Eveland[257] is the leading case in point. Here the railroad had challenged its South Dakota assessment

[255] See index under "Replacement cost."

[256] Ravage (41 *Yale L.J.* at 495, n. 31) finds that original cost is given minor weight and is sometimes rejected. Cincinnati Southern Ry. v. Guenther, 19 Fed. 395 (C.C. Tenn. 1884); In re Oklahoma Gas & Electric Co., 67 Okla. 301, 171 Pac. 26 (1918). For the nature of its application when used, he cites State v. Central Pacific Co., 10 Nev. 47, at 74 (1875), quoted with approval in Great Northern Ry. v. Okanogan County, 223 Fed. 198 (E.D. Wash., 1915). In tax cases, no less than in rate cases, the courts frequently admit evidence of original cost without explaining their theory of its relevance.

[257] 13 F. (2d) 442 (C.C.A. 8th 1926).

of $41,000,000, for the year 1922. The tax board did not reveal its method of valuation. But the Interstate Commerce Commission's valuation was $35,000,000, although the railroad itself had claimed a value of $42,000,000 before that body. The book value of the pertinent assets was $52,000,000, and replacement cost new was estimated at $47,000,000. The railroad paid a tax on a valuation of $29,000,000 and sued for an injunction against the collection of the balance, which was granted.

The evidence on which the company successfully relied was directed mainly to the proof that a valuation in excess of $29,000,000 was justified neither by a stock-and-bond test (whether based on current price quotations or on a 5-year average), nor by a capitalized-income test. No testimony seems to have been offered as to the value of the entire system on a capitalized-income basis. But the company presented data which (on the basis of an unstated method of allocation) indicated that the South Dakota portion of its road was making no net earnings whatever. The stock-and-bond value of the entire system was allocated by a relative-operating-revenue formula which, in our opinion, was thoroughly untrustworthy.

For present purposes the important parts of the opinion are those belittling cost data and distinguishing between tax valuations and rate-making valuations:

> In determining the value of the property of a railway company . . . , many classes of evidence are competent, but (1) the value of the use of such property in the operation of its railroads and its net revenue from such use, and (2) the current market value of its stocks and bonds are among the most persuasive and authoritative—far more so than the cost of the property or the cost of its reproduction new in cases in which the property is in operation and has been for many years.
>
> . . . .
>
> We are unable to resist the conclusion that the tax commission of South Dakota and the court below . . . fell into a decisive error of law in that they failed to give to the fact that the plaintiff derived no substantial net earnings from this property in South Dakota in 1921, or in any of the four previous years, and to the market value of the stocks and bonds of the plaintiff, the decisive influence in determining the value of the property under consideration to which they were entitled.

Referring to the Interstate Commerce Commission's valuation and to private engineering appraisals, the court said:

> But these valuations were not for the purposes of taxation, wherein use for railroad purposes and market value of stocks and bonds are chief factors,

but for rate-making purposes, wherein a very different basis for valuation prevails.

However, the court conceded that cost evidence was entitled to some weight:

There is no doubt that neither the net revenue of an operated railroad, nor the current market value of its stocks and bonds, nor any other class of competent evidence is the sole criterion by which the value of railroad property for purposes of taxation must be determined. But there are some classes of evidence upon this subject that under the established rules of law and evidence and in reason are entitled to far greater influence in determining such value than others.

Two years after the decision in the *Eveland* case, the Circuit Court of Appeals for the same circuit, in *Harris Trust & Savings Bank v. Earl*,[258] refused to upset a railroad assessment challenged on the ground of low earnings. It based its refusal on the grounds that the evidence of low earnings was weak, that the cost evidence abundantly justified the assessment, and that no evidence of stock and bond prices had been presented. Said the court:

It is earnestly urged upon us by the appellants that valuation of railroad property for taxation, at least under the circumstances in this case, should be determined, if not altogether, at least most largely, from a consideration of the earning capacity of the property. . . .

But it is not the law that the valuation of railroad or other property for taxation purposes is to be determined from any single factor. As bearing upon the proper result, many facts have evidential value. Certainly, among others, are to be considered original cost, cost of reproduction less depreciation, bonded indebtedness, current market value of stocks and bonds, and earning capacity. Of these the two last named are of the greatest significance [citing the *Eveland* case]. But earning capacity and actual earnings are by no means identical. What the property efficiently managed should have earned, and not what it has earned under incompetent operation, is the earning capacity that throws light on value.[259]

As to the precedent of the *Eveland* case, the court said:

The case cited by no means holds that earning capacity is completely to overshadow other factors. Indeed, in that very case other factors were given

[258] 26 F. (2d) 617 (C.C.A. 8th, 1928).

[259] It is a generally accepted legal doctrine that "the value" of a business enterprise, at least for tax purposes, means such a value as would be realized under competent management. See, for example, State v. Virginia & T.R.R., 24 Nev. 53, 50 Pac. 607 (1897). In practice, however, as Ravage points out (41 *Yale L.J.* at 496), "most courts have been satisfied to use actual earnings."

such consideration as that a $29,000,000 valuation was inferentially held fair on railroad property producing substantially no net earnings whatsoever.

One of the ablest of the recent opinions on enterprise valuation is that in *Northern Pacific Ry. v. Adams County*,[260] written by Judge Webster sitting as district judge. Certain aspects of the case will not be treated here, as they concern allocation formulas rather than the valuation of an entire enterprise—a subject discussed in detail in the next two chapters. But as to the valuation of an entire enterprise, the case is important for the material, though minor, weight that it gave to replacement-cost data.

The case concerned the validity of assessments for 1925, 1926, and 1927, placed by the Washington tax board upon the Northern Pacific, the Chicago, Milwaukee, St. Paul & Pacific, and the Spokane, Portland & Seattle railroads. The board did not reveal its methods of valuation. But the special master held all the assessments excessive. For the first two roads he used the stock-and-bond test, averaging the market prices during the preceding year. For the Spokane road, the securities of which were closely held by the Northern Pacific and the Great Northern, he capitalized at 7 per cent the reported net earnings of the previous year. Replacement cost was completely rejected by him, because "it bears no logical relation to value for taxation."

Judge Webster agreed with the master in holding the assessments invalid. But his appraisal procedure was quite different and far more plausible. He first drew an important distinction between the problem of testing the legal validity of the commission's assessments, and the problem of revaluing the properties, once these assessments had been held invalid. As to the former problem, he said:

> Inasmuch as the Legislature of Washington has not defined specifically how railroad property shall be valued for taxation, I am of the opinion that the proper way of testing whether the action of the state tax commission can be upheld is to inquire whether under *any* legally authorized method or methods its determination can be justified and sustained. (Our italic.)

While he held the use of depreciated replacement cost to be permissible, he distinguished its use in tax cases from its use in rate cases:

> Valuation for rate-making purposes and valuation for taxation purposes are not necessarily the same; the former being a basis upon which the corporation is entitled to a fair return, if it can succeed in earning it, the latter being that reflected by the use of competent factors and elements reasonably

[260] 1 F. Supp. 163 (E.D. Wash., 1932), *rev'd in part but not on the merits*, 72 F. (2d) 816 (C.C.A. 9th, 1934).

calculated to disclose the actual results in fact enjoyed by the practical operation of the utility or which ought to have been obtained under competent, honest, and economical management—the one measuring what is permissible, the other what is achieved or should have been achieved. With this fundamental distinction in mind, it is permissible to give consideration to reproduction cost in valuing railroad property for taxation, but in this field it is a far less influential factor than it is in the process of fixing a rate base. . . . Where other means of finding value are not available, reproduction cost may exert great influence, but, where factors are at hand directly shedding light on what the owner actually enjoys in the use of the property for the purpose to which he has devoted it, reproduction cost may have very scant value. After all, its evidential worth as a factor in ascertaining market value must be found in the relationship which it bears to actual results or what ought to have been accomplished in the use of the property, and weight must be given it in the light of such relationship, taking into consideration the peculiar facts of the case in hand.

Judge Webster then computed the values of the Northern Pacific and the St. Paul properties according to (*a*) stock-and-bond value, (*b*) earnings capitalized at 6 per cent, (*c*) an average of the two, and (*d*) an average of the two and of the valuation of the Interstate Commerce Commission. Each of these four values was averaged over periods of 1, 3, and 5 years, and each was allocated according to relative operated track mileage, relative Interstate Commerce Commission valuations, and according to an average of the two. The court chose these two allocation factors because they were the most favorable to the validity of the assessments.

But even this resort to various favorable alternatives did not support the assessments:

A study of the calculations will make it plain that, whenever a figure is reached which even approximately approaches the amount of the assessments, either unwarranted weight is given to reproduction cost, either as an item of base value or as a factor in allocation, which the law will not permit, or a peak year of earnings is arbitrarily chosen which palpably does not reflect average conditions over a reasonable period of time, or by the use of both methods in conjunction.

By somewhat similar reasoning the court found the Spokane assessment invalid. To be sure, it rejected the master's 7 per cent capitalization rate in favor of 6 per cent; it criticized his use of a single-year's record of earnings, denying the force of his apparent assumption that "since assessments of railroad operating property are to be made annually, the net earnings should be considered annually"; and it conceded that weight might fairly be given to replacement-cost data.

But even with these modifications, the assessment could have been sustained only if Interstate Commerce Commission valuations were accorded weight equal to that of earnings:

Surely, in the face of actual results, it will not be contended that reproduction cost should be given equal weight with operating net income in this case. The use of such a method would involve nothing short of oppression. Such an arbitrary combination of factors would involve palpable abuse of discretion, or the utter lack of the use of discretion, and would have nothing substantial in which to rest. Relevant factors of value must be used in the exercise of judgment—not merely by striking averages—and the facts of the particular case must be given reasonable consideration.

All of the challenged assessments having been invalidated, it then behooved the court to compute valuations upon which the roads were to pay taxes as a condition to securing injunctions against the collection of taxes on any higher valuations. Commenting on this problem, Judge Webster said:

Happily, in the discharge of this duty, I am in a somewhat broader field, in that I am not hampered by the restrictions which the law places about me in reviewing the actions of assessing and taxing officials. In valuing the property myself, I have more freedom of choice in selecting and appraising relevant factors of value and in the adoption of methods which, in my judgment, are best calculated to reflect reliable and trustworthy results.

The court then declared in favor of the composite method, saying:

I feel that in both reason and authority it is infinitely safer, where a number of relevant evidential factors are available, to take a composite view based upon all relevant elements and give to each in the exercise of sound judgment that weight and consideration which the peculiar facts of the case in hand justify and require. By using in combination a number of factors, each evidential element serves as a check and balance upon the others, or at least upon some of the others.

In the use of a composite method, the court adopted the position of the *Eveland* case that the stock-and-bond and capitalized-earnings methods, "when averaged over a reasonable period of time and taking care to avoid the encountering of unusual or abnormal conditions," were to be given primary weight, but nevertheless were to be "applied with due circumspection and not slavishly embraced." Depreciated replacement cost and original cost were to be accorded secondary weight and were to be cautiously used. As to the former,

Its use in the field of ascertaining value for taxation must be a careful and well-considered use, and the facts of the case in hand must ever be kept in

the foreground, lest it play a part or exert an influence out of all reasonable proportion to its relevancy to the question.

Thereupon the court computed system values by giving to stock-and-bond and earning values each a 40 per cent weight and by giving to the Interstate Commerce Commission valuation the remaining 20 per cent weight.[261] In the case of the Spokane road, where stock-and-bond data were not available, 80 per cent weight was given to earning value and the remaining 20 per cent to the Interstate Commerce Commission valuation. Earnings were capitalized at 6 per cent. For the 1925 and 1926 assessments, the court used a 3-year average of stock and bond prices and of earnings. A longer period was not used because the court deemed it "advisable not to include the years which reflected the disturbed conditions following as an aftermath of the World War and the confusions and dislocations immediately following the termination of Federal control of railroads." For the 1927 assessment, a 4-year period was used.

The Interstate Commerce Commission valuation was included in the formula, not as a matter of general rule, but for special reasons. All three roads were of excellent construction, and their "facilities are capable of a much higher degree of service than they have yet been called upon to perform. . . . In the march of progress, if greater demands were made upon the property, the facilities would be ready at hand, and would not have to be thereafter constructed." In the case of the St. Paul railroad, moreover, the court noted that the management could have effected substantial economies and thus have increased the net earnings, and that the western portion of the road "is of comparatively recent construction, and naturally passes through a territory which is not yet highly developed." As to the Spokane road, the company was controlled by the Northern Pacific and Great Northern, and "this ownership may give rise to the operation of the property in a manner which does not entirely reflect its actual earning capacity if no such joint ownership existed. . . . "

The cases already discussed are typical of the majority of Federal opinions in according minor weight to replacement-cost estimates and in distinguishing between tax value and rate-making value. But a

[261] The assignment of definite weights to different indices of value is somewhat rare in the legal valuation of an entire enterprise, although it is more frequent in the construction of an allocation formula. Usually, a court which uses an eclectic method of valuation merely expresses a "judgment" unsupported by a formula. Ravage notes this point, although he cites Chicago, Rock Island & Pacific Ry. v. State, 111 Neb. 362, 197 N.W. 114 (1923), for use of a mathematical average of the results of various methods.

few Federal judges have denied the validity of the distinction.[262] For example, in *Railroad & Telephone Cos. v. Board of Equalizers of Tennessee*[263] a district court violently objected to an assessment justified by counsel on the basis of the stock-and-bond and capitalized-earnings methods, and approved instead the much lower valuations which it thought would result from the application of the principles of rate-making value. We quote from the opinion:

> And it is curious to note the apparent tendency in some decisions to hold to the stock and bond basis in fixing values at high figures for the purpose of taxation, while rejecting such a method in arriving at true value for the purpose of regulation of charges. . . . Where true value is a constitutional requirement, as in Tennessee, it would seem to follow logically that such value, for the purpose of taxation, must be substantially the same thing as when value is inquired about for the purpose of regulation.

Great Northern Ry. v. Weeks.[264] This case is important, not only as presenting the latest thought of the Supreme Court on enterprise valuation, but also as illustrating this Court's legal sleight of hand in simultaneously holding two contradictory positions: the position that value for tax purposes is essentially the same as value for rate-making purposes, and the position that, with respect to the very same property, the pertinent *methods* of valuation differ as between the two types of cases.

The disputed assessment was that made for the year 1933 by the state tax board of North Dakota. Although the board members failed to testify as to their valuation methods, the evidence indicated that, for the years 1929 to 1932, they had valued their segment of the Great Northern Railroad at an allocated share of a system value based on a 5-year average of a stock-and-bond valuation and a 5-year record of earnings capitalized at 6 per cent. During this period, both earnings and stock-market quotations had been declining, so that the 1933 assessment, had it been arrived at by the same formula, would have

[262] Ravage cites In re Assessment of Western Union Telegraph Co., 35 Okla. 626, 130 Pac. 565 (1912), as supporting an assessment far above the rate-making value fixed several years prior to the assessment date. Among the cases identifying the two values, he cites Washington Water Power Co. v. Kootenai County, 270 Fed. 369 (C.C.A. 9th, 1921), *modified*, 273 Fed. 524 (C.C.A. 9th, 1921); Mobile & Ohio R.R. v. Schnipper, 31 F. (2d) 587 at 592 (E.D. Ill., 1929); and State v. Savage, 65 Neb. 714 at 755, 91 N.W. 716 at 724 (1902). In the last case the court said: "The property can have but one true value, whatever may be the purpose of the investigation." See also the rate cases, *infra* pp. 1092–1108.

[263] 85 Fed. 302 (C.C.N.D. Tenn., 1897).

[264] 297 U.S. 135 (1936).

amounted to between $63,000,000 and $68,000,000, as compared to the 1932 assessment of $78,000,000. But instead of accepting this reduced assessment, the board applied the unabated 1932 assessment to the year 1933.

A defense of this apparently inconsistent procedure was attempted by the board's expert witness. He first justified the use of the stock-and-bond method and the capitalized-earnings method as presenting "the two best evidences of the value of a railroad." But he then testified that there had been a collapse in the stock market, which had "brought prices down to a figure that did not fairly represent the value of the property"; that "1931 and 1932 were the worst years in railroad history since the panic of 1893"; and that the net income from farms, the chief taxable property in the state, had also fallen off drastically. "If all assessments," he declared, "had been reduced to conform to actual market value, the state and its subdivisions would have ceased to function, as the revenue did not even approximate necessary expenses."

These arguments on behalf of the assessment were not deemed persuasive by the Court, which by a divided opinion held that there had been a violation of the "due-process" clause of the Fourteenth Amendment, and which enjoined the collection of taxes on a higher valuation than $68,000,000.

Speaking for the Court, Justice Butler first restated the position that he had taken several years previously as a distinguished counsel for the railroad companies, denying the validity of the oft-asserted distinction between tax value and rate-making value:

> The principles governing the ascertainment of value for the purposes of taxation, are the same as those that control in condemnation cases, confiscation cases and generally in controversies involving the ascertainment of just compensation.

Starting from this premise, one might suppose that he would then have turned to the accepted indices of value for rate-making purposes, emphasizing prevailing replacement costs and original costs, with appropriate deductions for depreciation and additions for "going value." In that event, he would probably have felt obliged to dismiss the railroad's petition, since, so far as the opinions in the case reveal, no evidence of structural costs had been introduced. Instead, he found the assessments invalid because they were not justified by the stock-and-bond data or the earnings data—types of evidence that are usually completely ignored, or at least given but little weight, in a rate case. According to the prevailing opinion,

. . . it clearly appears that the board had failed to give reasonable weight to the falling off of petitioner's traffic, gross earnings, operating income, the extraordinary shrinkage in values of railroad properties, the prices of commodities and securities generally. The value of petitioner's property varied with the profitableness of its use, present and prospective.

Apparently the basic reason behind the Court's decision lay in its disagreement with the testifying expert on the question whether or not the depression levels represented temporary or "relatively permanent" levels, at least in the case of railroads. Said Justice Butler:

The 1929 collapse and the decline progressively following it resulted in much lower levels of prices and values which at least as early as 1933 were to be regarded not as temporary but as at least relatively permanent.

And especially with regard to railroads:

Changed business conditions affecting petitioner's traffic coupled with competition from new methods of transportation precluded belief that prospective improvement in petitioner's business and earnings would within a reasonable time, if ever, be sufficient to justify the assessment in question.

Justice Stone wrote a vigorous dissenting opinion with which Justices Brandeis and Cardozo concurred. He declared that the decision of the state board to reject depression levels, as not indicating so-called "fair" or "real" values, was made in "the exercise of an authorized judgment, which courts cannot pronounce arbitrary merely because it does not conform to their own." But, conceding the over-assessment, he also insisted that the complainant had failed to prove that other properties in North Dakota were not likewise being over-assessed, and in fact had failed to even claim any such discrimination:

The feature of the decision which is especially a matter of concern is that for the first time this Court is setting aside a tax as a violation of the Fourteenth Amendment on the ground that the assessment on which it is computed is too high, without any showing that the assessment is discriminatory or that petitioner is in any way bearing an undue share of the tax burden imposed on all property owners.

. . . .

The burden of a property tax like the present is distributed by applying a rate of tax to the assessed valuation of all tangible property. Variation of either, without discrimination, affects the amount of the tax but not the equality of its distribution. The activities and expenses of government . . . do not cease in time of depression. They may increase. The state may meet those expenses by raising the valuation of tangible property, or by raising tax rates, or both, without infringing any constitutional immunity. Here the State, so far as appears, is raising the needed revenue and distributing the burden as in previous years, by continuing old valuations. However

high these valuations may be, if not discriminatory, they impose no unequal share of the tax burden on petitioner and cannot be said to be arbitrary or oppressive in the constitutional sense.

The prevailing opinion did not explain whether it considered a "grossly excessive assessment" *per se* a violation of the "due-process" clause, or whether such an assessment merely raised a presumption of discrimination, thus imposing upon the state the burden of presenting evidence to show that other property was proportionately overassessed.

IX. CONCLUSIONS

The central theme of this chapter, with many variations, has been the use of the concept of *enterprise value*, distinguished from so-called "physical value" or "asset value," as a basis of tax assessment. To be sure, only under a few taxing statutes, such as the Federal capital-stock tax, has this concept been applied with some approach to logical rigor. Most of the public-utility ad valorem taxes still make arbitrary distinctions between tangible and intangible values and still tend to identify the value of tangible assets with their estimated replacement cost minus a conventional allowance for depreciation. But even under these hybrid taxes, which are in a transition stage between a general property tax and an enterprise-value tax, the validity of the assessments is often tested by a valuation of the business as an organic unit or "going concern."

Under these circumstances, there arises the question, by what method the value of a business enterprise can best be estimated. Having discussed at length the various answers given by assessors and courts, we now feel called upon to express some opinions of our own. But these opinions are offered with the warning that the soundness of *any* annual tax measured by enterprise values is highly doubtful. The theoretical objections to taxes of this nature have been discussed in Sec. I of the present chapter. But even if these objections were not serious, the practical impossibility of annually redetermining the values of hundreds or thousands of business enterprises, with even a decent approach to accuracy, is a persuasive reason against making the attempt. Alternative forms of business taxation, such as corporate-income taxes, excess-profits taxes, or even gross-earnings taxes, are far superior despite their conceded limitations.

As long, however, as the legislatures persist in their use of ad valorem taxes, the problem of finding the least objectionable method of valuing a business enterprise for tax purposes will also persist. Already we have discussed the general theory of enterprise valuation, in Chap. XII. There the point was made that (with certain qualifications)

value is *solely* dependent on a capitalization of *anticipated* earnings. But except in a small minority of cases, no appraiser lives who can forecast future earnings with justifiable confidence; and no formula, or any combination of formulas, is reliable.

What has just been said might seem to support those assessors and judges who refuse to be governed by any rule or method of valuation, such as the stock-and-bond method or the capitalized-realized-earnings method. Certainly an expert appraisal firm, engaged by a prospective buyer or seller of corporate property to make a careful estimate of "fair value," would refuse thus to be bound. Nevertheless, it is submitted that a fairly rigid method of valuation should be adopted for tax purposes—such a method as the New York Court of Appeals has applied under the special-franchise tax, or as the Illinois tax board has purported to apply under its stock-and-bond rule. Of course, valuations so reached will often be wide of the assumed goal. But repeated experience with assessments based on "judgment" or on a capricious choice between a number of alternative methods, suggests that they are even more arbitrary than are those controlled by formulas.

If we are right in preferring to accept as final the verdict of some valuation formula, we still face the question of choice between the various alternatives. Practically speaking, this choice must lie with one of three methods, or else with some standardized composite: (*a*) the stock-and-bond method, (*b*) the capitalized-realized-earnings method, and (*c*) the depreciated-replacement-cost or asset-value method.

If the outstanding securities of most corporations had an established market price, the stock-and-bond method, despite its shortcomings, would perhaps be preferable because of its ease of application. Unfortunately, however, this condition is not realized, with the result that the method is inapplicable except to larger corporations, and by no means invariably to them. Even so, it might be applied to those companies whose stocks and bonds have a quoted market price. But the difficulty of avoiding discrimination between assessments based on this method and assessments based on some alternative method, while not insurmountable, is nevertheless serious.

A capitalization of recent annual earnings, averaged over a period of from 3 to 5 years, and with standardized rates of capitalization, is almost certainly the most generally applicable method. To be sure, it would in effect convert an ad valorem tax into a kind of income tax. But this result may well be deemed in its favor. In one respect, however, it would differ from the familiar form of a corporate-income tax—in its use of an average of several years' earnings. This difference would

have some merits in reducing the fluctuations in annual revenues received by the government.

In the litigated cases, assessors often contend that the capitalized-earnings method is inapplicable to companies with no current net earnings. Here some alternative method of valuation is often applied, especially so with taxes that are based on the entire value of the corporate property and not merely on "corporate excess." No doubt, a business enterprise may be very valuable even if it has realized no net earnings during a given period preceding the date of valuation. Yet the practical difficulty of determining the amount of this value, except perhaps after an intensive study far beyond the scope of an assessor's office, raises doubt whether the attempt should be made. Although the taxation of companies without current net income is justifiable, resort to alternative minimum taxes, such as one based on gross receipts or on the costs of the tangible properties, may be preferable to a tax measured by a highly arbitrary valuation.

A valuation based on estimates of the replacement costs of corporate assets is not a valuation in any proper sense of the term and is utterly unacceptable under the premise that the assessment is really designed to measure enterprise value. Earlier in this chapter, however, we have indicated that it may be defended on the ground that the costliness of property, and *not* its value, is a preferable tax base.

The preference of some assessors and courts for a composite method of valuation has a certain plausibility as a statistical device for taking advantage of countervailing errors. But the device is too ineffective to overcome the serious objections to a composite method—the objections of greater complexity and of invitation to litigation. Moreover, no single compromise formula would be applicable to all cases; a variety of formulas would be required. On the whole, the advantages seem to lie with a fairly well-standardized application of a capitalized-earnings method.

Even if the problem of estimating the value of an entire business enterprise were settled, there would still remain the necessity of apportionment with respect to companies, the assets and business of which are not confined to a single taxing jurisdiction. Already this second problem has been touched upon in the foregoing sections. But it remains to be treated at length, in the two following chapters on the unit rule.